# Financial Awareness

**Mike Ward**
**Chartered Management Accountant**

**Business Fix Ltd**

# Biography

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- 1988 - Elected to Associate Membership of CIMA (Chartered Institute of Management Accountants)
- 2007 – Elected to Fellowship of CIMA
- 2004 – Elected to Membership of Inst of Directors

- 1998-2001 Finance Manager, First Glasgow
- 2001-4 Financial Controller, Ops Director, Catering
- 2004-8 Finance Director, The Essentiagroup
- 2008-9 Group Finance Director, E-net Computers
- 2009-10 Freelance Finance Director
- 2010-14 Finance Director, Heliex Power Limited
- 2015- Present, Freelance Finance Director
- 2015- Present, Group Finance Director, SRA Ventures
- 2017- Present, Non-Executive Director, Glasgow Colleges Regional Board

# Content

- Business structures – funding & ownership
- Accounting concepts, principles, terminology
- Balance Sheet
- The Profit and Loss Account
- Funds / Cash Flow Statement
- Return on investment and other key performance indicators
- Business Planning, Budgets & Forecasts

# Introductions & Business structures

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- Brief Introductions
- Financial Experience
- What are you looking to get out of today
- What kind of Business Structures are we familiar with ?

# Business structures

- Types of business structures
- Reporting Requirements
- Taxation Treatment
- Audit Requirements
- Bank & Funder Approach

# Sole Traders

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- Typically early stage start up or stand alone
- e.g. self-employed painters, plumbers
- Personal Liability for claims
- Report to HMRC only
- No external reporting
- No Audit Requirements
- Liable to Income Tax & NIC Class 2 & 4
- Funders will look for established traders

# Unincorporated Partnerships

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- Typically two or more individuals working together
- Perhaps have a partnership agreement
- e.g. self-employed barbers
- Joint & Several Personal Liability for claims
- Report to HMRC only
- No external reporting or audit requirements
- Partners individually liable to Income Tax & NIC Class 2 & 4
- Funders will look for trading history

# Incorporated Partnerships (1)

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- Typically several individuals working together
- Either Limited Partnership (LP) or Limited Liability Partnership (LLP)
- Usually have a partnership agreement
- e.g. legal firms
- Partners join & leave but partnership remains
- Joint & Several Limited Liability for claims

# Incorporated Partnerships (2)

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- Report to HMRC (Partnership Return)
- External reporting to Companies House
- Reporting requirements dependent on size (Balance Sheet, Employees & Turnover)
- Partners liable to Income Tax & NIC Class 2 & 4 (Individual Tax Returns)
- Funders will look for established partnerships

# Incorporated Companies (1)

- Private company limited by shares (Ltd)
- Private company limited by guarantee(Ltd)
- Public companies (PLC)
- Each takes on separate legal identity
- Protects individuals from claims
- Beware of personal liability exceptions
  - e.g. H&S, insolvency
- Company is owned by Shareholders
- Assets are owned by the Company

# Incorporated Companies (2)

- Articles of Association
- Shareholders General Meetings (AGM & EGM)
- Shareholder Reserved Matters
  - e.g. Appoint Directors, property purchase
- Executive directors run the business day to day
- Non-executive directors provide governance
- Board Meetings

# Incorporated Companies (3)

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- Profits distributed to shareholders by Dividend
- Report to HMRC (Company Return)
- External reporting to Companies House
  - Reporting requirements dependent on size (Balance Sheet, Employees & Turnover)
- Shareholders liable to Income Tax (Individual Tax Returns)
- Funders will look for established companies and / or assets against which to secure.
  - Personal Guarantees

# Company Structures Review

| | Liability | Profits Liable to Which Tax | Ownership | Reporting Requirement |
|---|---|---|---|---|
| **Sole Trader** | | | | |
| **Partnership** | | | | |
| **LLP** | | | | |
| **Company** | | | | |

# Company Structures Review

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| | Liability | Profits Liable to Which Tax | Ownership | Reporting Requirement |
|---|---|---|---|---|
| **Sole Trader** | **Unlimited** | **Income Tax & NIC** | **Individual** | **HMRC only** |
| **Partnership** | **Unlimited** | **Income Tax & NIC** | **Partners** | **HMRC only** |
| **LLP** | **Limited** | **Income Tax & NIC** | **Partners** | **HMRC & Co. House** |
| **Company** | **Limited** | **Corporation Tax** | **Share-holders** | **HMRC & Co. House** |

# Accounting Concepts

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- Double Entry
- Historical Cost & Revaluations
- Books of Entry / Adjustments / Journals
- Accruals & Matching
- Going Concern
- Prudence
- Materiality (by nature & by amount)
- Legislation & Guidance

# Accounting Concepts

- Double Entry
  - Basis of All Accounting
  - Italian in Origin
  - Every action has a corresponding re-action
  - e.g. Purchase sets up a liability
  - A Payment extinguishes the liability
- Debits (Dr) for Costs or Assets
- Credits (Cr) for Income or Liabilities
- What would the following Double Entries be ?
  - (Don't Turn The Page)

# Accounting Concepts

- What would the following have as a double entry
- Credit sale of one day's plant hire
  - Dr Debtors Cr Sales
- Purchase of a Excavator
  - Dr Assets Cr Creditors / Cash
- Use of a low loader to move plant
  - Dr Expenses Cr Creditors

# Accounting Concepts

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- Historical Cost & Revaluations
  - Default method for Accounts preparation is Historical Cost
  - Can be overridden by revaluation but only if substantiated e.g. Surveyors
- Books of Entry / Adjustments / Journals
  - Purchase Ledger
  - Sales Ledger
  - Cash Book
  - Reconciliations
  - Adjusting Journals

# Accounting Concepts

- Accruals & Matching
  - Ensures that all sales have associated / relevant costs
  - Requires Assets to be depreciated over their useful economic life
- Prudence
  - Requires pragmatism rather than optimism
  - E.g. provide against bad debts, write down investments

# Accounting Concepts

- Materiality
  - Allows judgement for minor entries
  - Matters may be material
    - by nature e.g. fraud or
    - by amount
- Going Concern
  - Does the entity have a viable future
  - Judgement call
  - Accounts preparation based on 1 year

# Accounting Concepts

- Accounts Preparation Based on Legislation and on Guidance
  - Companies Act 2006
  - FRS
    - Financial Reporting Standards
  - FRSSE
    - Financial Reporting Standard for Small Entities
  - FRS102
    - Financial Reporting Standard 102
  - Terminology
    - Any Other Terms ?

# The Balance Sheet

- Also known as Statement of Financial Position
- Snapshot of Position at a FIXED point in time
- Usually at the end of an Accounting Year or Period
- Retained Profit Agrees with P&L Account
- Always Balances !!!

# The Balance Sheet

- Fixed Assets – Tangibles, Intangibles & Investments
- Current Assets
- Current Liabilities
- Working Capital
- Long Term Liabilities
- Shareholders Funds
  - Share Capital
  - Retained Profits
- Financial Ratios

# The Balance Sheet

- Where do the following items go ?
  - Amounts due from Customers
  - Amounts due to Suppliers
  - Outstanding Tax (PAYE / NIC / Corp Tax)
  - Prepayments
  - Owned Plant
  - Share Capital
  - Current Year Profits
  - Plant Under Operated Lease

# The Balance Sheet

- Fixed Assets
  - Tangibles
  - Intangibles
  - Investments
- Current Assets
  - Bank Credit Balances
  - Amounts Due from or Prepaid
- Current Liabilities
  - Bank Overdrafts
  - Amounts Due to or Prepaid
- Net Current Assets - Working Capital

# The Balance Sheet

- Long Term Liabilities
  - Bank Loans
  - Amounts Due in Over 1 Year
- Shareholders Funds
  - Share Capital
  - Retained Profits

# The Balance Sheet

## Side by Side format

| Assets | | Liabilities |
|---|---|---|
| Fixed Assets | | Current Liabilities |
| Current Assets | | Long Term |
| | | Share Capital |
| | | Profits |
| Total Assets | = | Total Liabilities |

# The Balance Sheet

## Current Format

Fixed Assets

- Current Assets
- Less Current Liabilities
- Net Current Assets

Total Assets Less Current Liabilities

Long Term Liabilities

Net Assets

Share Capital

Retained Profits

Shareholders Funds

**Bob's Plant Company**

**Balance Sheet as at 30 September**

| | |
|---|---|
| Plant & Equipment | |
| Cost | 591,757 |
| Acc Depreciation | (278,877) |
| Total | 312,880 |
| Current Assets | |
| Trade Debtors | 695,042 |
| Bank | 132,019 |
| Sundry Debtors | 118,097 |
| Total | 945,158 |
| Amounts Due in under 1 Year | |
| Trade Suppliers | 426,531 |
| PAYE & NIC | 148,553 |
| VAT | 16,005 |
| Corporation Tax | 101,798 |
| Lease Payments | 78,124 |
| Sundry | 115,801 |
| Total | 886,812 |
| Net Current Assets | 58,346 |
| Total Assets Less Current Liabilities | 371,226 |
| Amounts Due in over 1 Year | |
| Lease Payments | 112,571 |
| Total Assets | 258,655 |
| **Shareholders Funds** | |
| Share Capital | 1,000 |
| Profits brough forward | 87,369 |
| Profits Year to Date | 171,286 |
| Total | 258,655 |

# Profit & Loss

- Also known as Income Statement
- Revenue
- Cost of Sales
- Overheads – Admin, Selling
- Interest
- Taxation
- Profit - Post-Tax, Pre-tax, EBIT, EBITA, EBITDA, Operating

# Profit & Loss

- Covers a Period of Time
  - Note contrast to Balance Sheet
- Usually runs to a Balance Sheet Date
- Profits / Losses are then carried onto the Retained Profits Section of the Balance Sheet

# Profit & Loss

## Gross Profit Level

- Revenue / Sales
  - Income from normal activities
  - Invoiced sales, not cash receipts
- Cost of Sales
  - Costs directly associated with sales
  - E.g. Operator Labour, Fuel, Materials
- Gross Profit
  - Revenue Less Cost of Sales

# Profit & Loss

## Operating Profit

Overheads

Admin and Selling Costs

Gross Profit Less Overheads

= Profit Before Interest & Tax (PBITDA / EBITDA)

Less Depreciation & Amortisation

= Profit Before Interest & Tax (PBIT / EBIT)

Also known as Operating Profit

# Profit & Loss

## Pre and Post Tax

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**Profit Before Interest & Tax (PBIT / EBIT)**

**Less Interest**

**= Pre-tax Profit**

**Less Taxation**

**= Post-tax Profit**

**Bob's Plant Company**
**Profit & Loss Report**
**Month & Year to Date April to Sept**

| Revenue & Direct Costs | Sept | Year To Date |
|---|---|---|
| Contracted Income | 523,634 | 3,457,214 |
| | | |
| Material | (224,865) | (987,755) |
| Labour | (188,802) | (1,208,122) |
| Travel & Accom | (63,253) | (267,333) |
| Sub-contractors | (22,110) | (139,449) |
| Others | (15,606) | (82,876) |
| Total Direct Costs | (514,636) | (2,685,535) |
| | | |
| Gross Profit | 8,998 | 771,679 |
| | | |
| Overheads & Other Costs | | |
| Expenses | (67,122) | 482,946 |
| Earnings Before Depreciation & Interest (EBITDA) | (58,124) | 288,733 |
| Depreciation | (13,107) | (78,681) |
| Operating Profit (EBIT) | (71,231) | 210,052 |
| Interest Received / (Paid) | 565 | 4,056 |
| Net Profit Before Tax | (70,666) | 214,108 |
| Provision for Corporation Tax | 14,133 | (42,822) |
| Profit After Tax | (56,533) | 171,286 |

# Funds Flow

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- Profit v Cash
- What is added back
- Asset Purchase & Disposals
- Funding
- Changes in working capital
- Tax & Interest Payments
- Movement in Cash Balances

# Funds Flow
## Profit & Cash

- What is the difference
  - Long Term
  - Short Term
- Funds Flow Reconciles the two elements
- What level of profit is used
  - Operating ?
  - Pre-tax ?
  - PBIT ?

# Funds Flow

## Adjustments to Profit

- Start with Operating Profit
  - Add Back Non-cash Items
  - Depreciation, Amortisation
  - Changes in Debtors and / or Creditors
- = Net Cash Generated from Operations
- Investment Activity
  - Purchase of Assets
- Funding Received / repaid
  - Bank Loans
  - Share Issues
  - Funding for Assets (plant or working)

# Funds Flow

## Increase / Decrease in Cash

- After Adjustments Gives
- Net Increase / Decrease in Cash

- Should Equal
  - Closing Cash Position
  - Less Opening Cash Position

**Bob's Plant Company**
**Funds Flow Statement**

| **From** | **April** |
|---|---|
| **To** | **September** |
| | |
| Operating Profit | 210,052 |
| Add Back Depreciation | 14,305 |
| Net Inflow from Operations | 224,357 |
| | |
| Application of Funds | |
| Acquisition of Fixed Assets | (32,331) |
| | |
| Movements in Debtors & Creditors | |
| (Increase) / Decrease in Debtors | (129,172) |
| Increase / (Decrease) in Creditors | (25,236) |
| Increase / (Decrease) in Amts > 1 Year | 9,939 |
| Total | (144,469) |
| | |
| Interest Received | 4,056 |
| | |
| Net Inflow (Outflow) of funds | 51,613 |
| | |
| Represented By | |
| Closing Bank Balance | 132,019 |
| Opening Bank balance | 80,406 |
| Increase / (Decrease) | 51,613 |

# Business Ratios

- Profit Ratios – Net, Gross Profit %
- Balance Sheet – Liquidity, Net Assets
- Debtor Days, Creditor Days, Stock Turn
- Bank Ratios – Loan to Value, Interest Cover
- Return on Capital Employed (ROCE)
- Other Ratios – e.g. per employee

# Business Ratios

## Profitability

- Gross Profit
  - Sales Less Cost of Sales
- Gross Profit %
  - Gross Profit / Sales x 100
- Net Profit %
  - Net Profit / Sales x 100
- Stock Turn
  - Stock / Cost of Goods  x 365

# Profitability Ratios

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**Profit & Loss Report**
**Month & Year to Date April to Sept**

| Revenue & Direct Costs | Sept | Year To Date |
|---|---|---|
| Contracted Income | 523,634 | 3,457,214 |
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# Profitability Ratios

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**Bob's Plant Company**
**Profit & Loss Report**
**Month & Year to Date April to Sept**

| Revenue & Direct Costs | Sept | | Year To Date | |
|---|---|---|---|---|
| Contracted Income | 523,634 | | 3,457,214 | |
| Total Direct Costs | (514,636) | | (2,685,535) | |
| Gross Profit | 8,998 | 1.7% | 771,679 | 22.3% |
| Overheads & Other Costs | | | | |
| Expenses | (67,122) | | 482,946 | |
| Earnings Before Depreciation & Interest (EBITDA) | (58,124) | -11.1% | 288,733 | 8.4% |
| Depreciation | (13,107) | | (78,681) | |
| Operating Profit (EBIT) | (71,231) | -13.6% | 210,052 | 6.1% |
| Interest Received / (Paid) | 565 | | 4,056 | |
| Net Profit Before Tax | (70,666) | -13.5% | 214,108 | 6.2% |
| Provision for Corporation Tax | 14,133 | | (42,822) | |
| Profit After Tax | (56,533) | -10.8% | 171,286 | 5.0% |

# Business Ratios
## Balance Sheet

- Debtor Days
  - Debtors / Sales plus VAT x 365
- Creditor Days
  - Creditors / Purchases plus VAT x 365
- Stock Turn
  - Stock / Cost of Goods  x 365

# Business Ratios

## Balance Sheet

- Debtor Days Example For Bob's Plant Hire
  - Sales for 6 month's - £3,457,214
  - Debtors as at 30 Sept - £695,042
- Annual Sales would be
  - 2 x £3,457,214 = £6,914,428
  - Add VAT to compare against Debtors
  - + 20% = £8,297,314
- Debtor Days = Debtors / Annual Sales x 365
  - = 695,042 / 8,297,314 x 365 = 30.6 days

# Business Ratios

## Balance Sheet

- Working Capital
  - Current Assets less Current Liabilities
- Current Ratio
  - Current Assets / Current Liabilities
  - Looking for > 1:1
- Quick Ratio (aka Acid Test Ratio)
  - (Current Assets less Cash )/ Current Liabilities
  - Looking for >= 1:1

**Bob's Plant Company**

**Balance Sheet as at 30 September**

| | |
|---|---|
| Plant & Equipment | |
| Cost | 591,757 |
| Acc Depreciation | (278,877) |
| Total | 312,880 |
| Current Assets | |
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| Total Assets | 258,655 |
| **Shareholders Funds** | |
| Share Capital | 1,000 |
| Profits brough forward | 87,369 |
| Profits Year to Date | 171,286 |
| Total | 258,655 |

- **Working Capital**
  - **Current Assets less Current Liabilities**
  - **£945,158 less £886,812 = £58,346**
  - **Also equals Net Current Assets**
- **Current Ratio**
  - **Current Assets / Current Liabilities**
  - **£945,158 / £886,812 = 1.06**
  - **Looking for > 1:1**
- **Quick Ratio (aka Acid Test Ratio)**
  - **(Current Assets less Cash )/ Current Liabilities**
  - **(£945,158- £132,019) / £886,812 = 0.92**
  - **Looking for >= 1:1**

# Business Ratios

## Funding Ratios

- Loan to Value
  - Current Borrowings / Asset Value x 100
- Interest Cover
  - Profit / Interest Payable
- Rental Income Interest Cover
  - Rental Income / Interest Payable
- Gearing Ratio
  - Borrowings / Shareholder Funds

# Business Ratios

## Return on Capital Employed

- Return on Capital Employed (ROCE)
  - Profit After Tax / Shareholder Funds
- Price Earnings Ratio
  - Profit After Tax / Share Price
  - Needs to be a listed company or other market price available

# Business Ratios

## Other Ratios

- Industry Specific
  - Plant Utilisation
  - Revenue Per Hour
  - Profit Per Hour
  - Maintenance Costs Per Hours
  - Often known as Key Performance Indicators (KPI's)

# Business Planning

- Strategic Plans
- SWOT & PEST Analyses
- Business Plans
- Annual Budget
- Performance against Budget
- Re-forecasting
- Capital Expenditure Appraisal Methods

# Business Planning

## Strategic Plans

- Long Term
- Used to assess the potential of the business
- Agree Long Term Goals
  - e.g. new markets, growth ambitions
- Main focus is on market & financial
- Often takes place off-site

# Business Planning

## Strategic Plans (2)

- Set Vision
- Appraise current performance and capabilities
  - SWOT
    - Strengths, Weaknesses, Opportunities & Threats
  - PEST Analysis
    - Political, Economic, Social & Technical
- Identify Action Plans to take advantage of opportunities and reduce risk

# Business Planning

## Business Plans

- Flows from Strategic Review
- 3 to 5 year timescale
- Detailed Projections
  - Markets
  - Investments
  - Sales, Costs & Profit
- Detailed Action Plans
- Agree measurable actions

# Business Planning
## Annual Budgets

- 1 Year Detailed Budgets
- Revenues by sector, geography, division
- Plant utilisation
- Gross & Net Profit
- Balance Sheet
- Debtor days, working capital, overdraft

# Business Planning

## Performance against budget

- Monthly / Quarterly Management Accounts
- Performance against Budget
  - Actual v Budget
  - Absolute & Percentage
  - Period & Year to Date
- Re-forecasting
  - Monthly or Quarterly
  - Revise Budget based on actuals and current knowledge
- Remedial Actions

# Business Planning

## Capital Expenditure Appraisal

- Incremental Cash Flow
- Accounting Rate of Return
- Payback Periods
- Discounted Cash Flow (DCF)
  - Net Present Value
  - Internal Rate of Return

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# Financial Awareness

## Any Questions / Round up

**Mike Ward**
**mike@mwamail.co.uk**
**mike@giffnockwards.co.uk**
**07951-966206**