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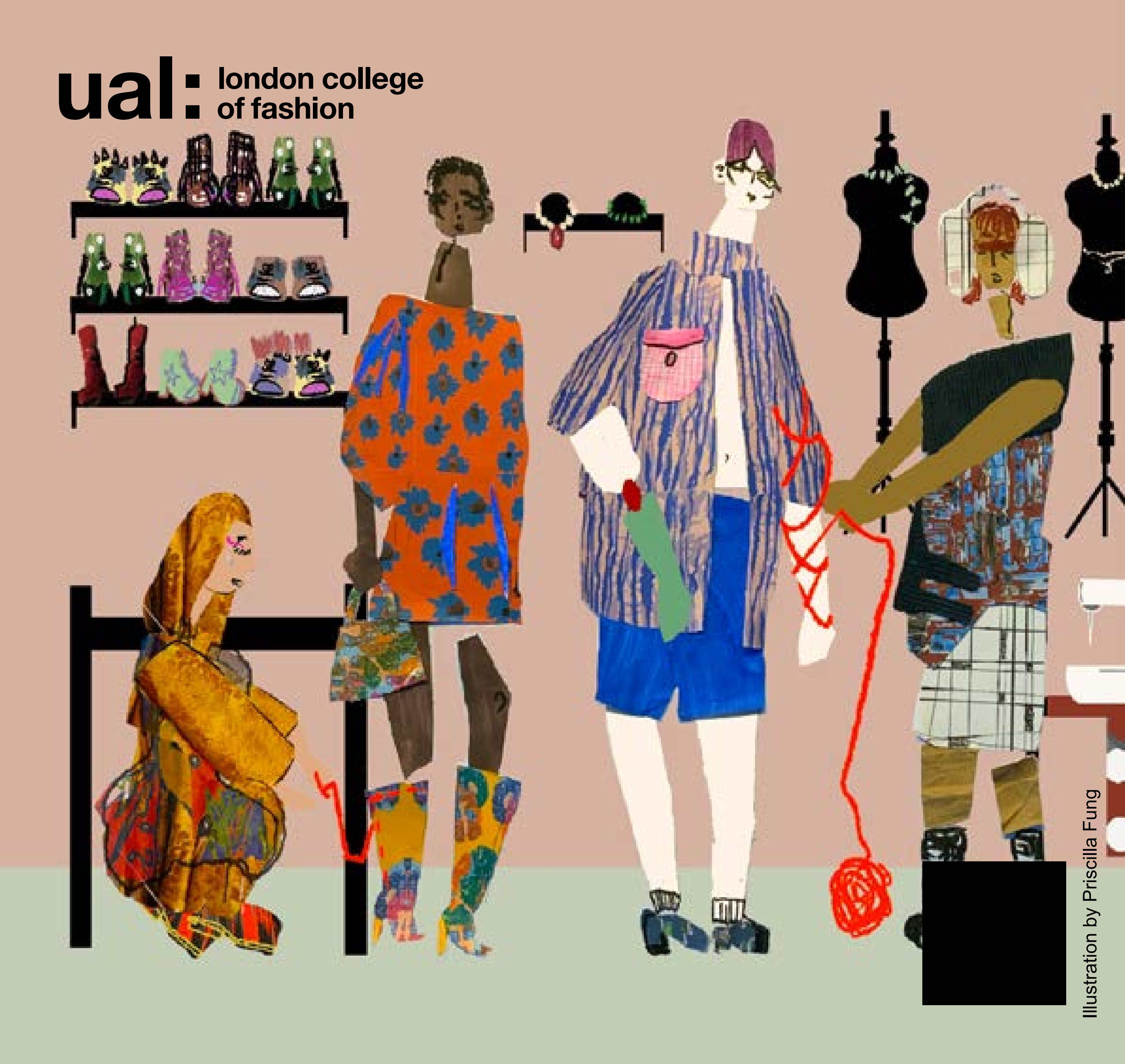


Illustration by Priscilla Fung

How to manage basic business finances

Profit and Loss

The Profit and Loss report (PL) sets out the income and expenses of the business. To create a viable business, sales need to exceed costs. The PL is crucial to assessing the viability of the business and its business model. Bear in mind though that new business ventures can take time to reach profitability. Typically, at least 2-3 years.

Heading	Notes
Sales aka revenue or turnover	The sales activity not cash received excluding VAT
less cost of goods sold	.i.e. the cost of the “ingredients” of the sale
= Gross Profit	(this is the value that the business has added)
less Overheads (Fixed Costs)	(the costs of running the business)
= Operating Profit or EBIT	(earnings before interest and tax)

Costs

Costs are broken down into two main categories:

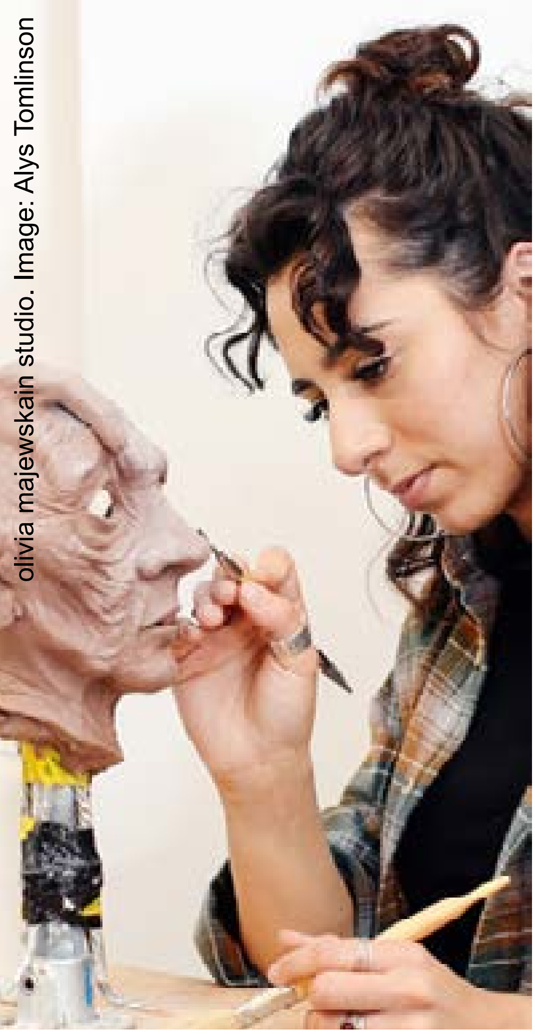
- Cost of Goods Sold: Also known as direct costs, which you can see in your product or service, they typically vary with the level of sales
- Overhead Costs: Also known as Operating Costs, which are relatively fixed in the short term.

An example to explain:

In a cleaning business, the chemicals & cleaners are cost of goods sold, while the office costs and marketing are overheads.

Gross Margin

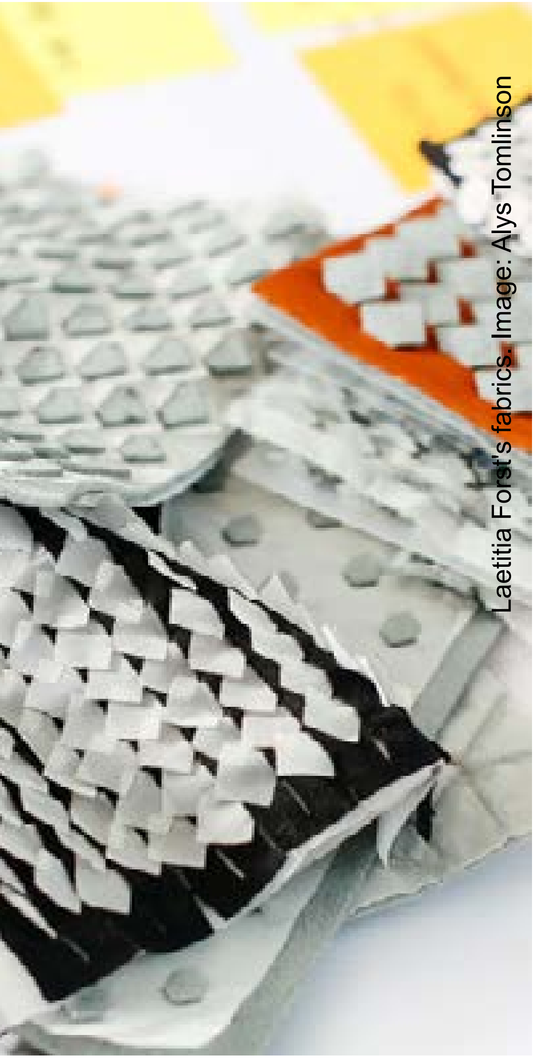
Sales less direct costs is your gross profit, meaning the value added you have created. For example, you took material and zips and turned them into a higher value garment. It is this gross profit that is going to cover your overheads if you



olivia majewskain studio. Image: Alys Tomlinson

divide gross profit by sales (and multiply by 100), you get Gross Profit margin
Gross profit table descriptor:

	Month 1	Month 2	Month 3
Sales	100	200	300
=Cost of sales	20	50	100
=Cost of profit	80	150	200
Gross profit margin (GP/ Sales) x 100	80%	75%	66.6%



Laetitia Forst's fabrics. Image: Alys Tomlinson

What this table highlights is the importance of watching trends. Looking at the percentage can help with this. On the face of it, gross profit in money is increasing, but when you look at the margin percentage it is dropping. This may be because the prices have deliberately been dropped to sell more. Maybe costs are increasing or maybe there is manufacturing wastage. It is also possible that maybe sales aren't £300, and someone is taking cash out of the business, which would prompt an investigation.

Breaking even

Breakeven is the point where sales equal total costs to an even amount. There is no profit made, but also no debt. For a new business or new business unit, this is the first financial milestone. Here is an example to calculate breakeven:

- Selling price of skirt is £30.00
- Manufacture & packaging (i.e. Ingredients) cost £10.00
- Gross Profit" is therefore £20.00 (= selling price minus making cost)
- If overheads are £20,000 then breakeven is selling 1,000 skirts

You can express break even either in units needed to be sold, or level of sales. Break even can be over any time period, for example over a week, a month or per annum. Be aware that the breakeven point, will be affected by your sales mix if some of your products have higher margins than others.

Once you have calculated breakeven, it acts as a useful sanity check. You can then consider if it is a realistic target/volume to achieve break even from this location, with this much marketing, and other factors impacting costs and efficiency. If the answer is no, you need to revisit your pricing, margins or overheads to develop a formula that feels right. You are now using the numbers to create your business model!

Business Model

Sales Model

What is your offer? What is your "elevator" pitch? What would an A5 flyer look like for your business? What is the retail price?
When Ikea plan a new product, they start with the price. How big is the market? (Based on what research?) Who is using your product/service? Describe your perfect customer. How often do they buy? How many do they buy? In other words, what is lifetime value of a customer? Crucially, how do you plan to reach them? Will it be online or via distributors? What is your existing connectivity with these customers?

Gross Profit Model

Sales price minus cost of sales = gross profit
What is the cost of making or supplying one product or service? You will be able to reduce unit cost as volumes increase. How does this compare to selling price? (Don't try and be a price leader). Is there enough gross profit margin? What can be added in or taken out of product to enhance the offer for the customer?

Overhead Model

Where are you based? Headcount (including who does your finances!). How do you plan to reach your targets? At what cost, or cost per customer acquisition? When is breakeven? What does it look like, how many garments or users needed?

Working Capital Model

When do you get paid/when do you pay? How do you take payment? How much stock do you need? Burn rate and cash flow "runway".

Asiah Ali in the studio. Image: Alys Tomlinson

Investment Model

How much finance do you need? What are you going to spend it on? What milestone will this reach? Pre-money and post money value? What is the mix of debt and equity? Are you going to pre-sell? For example, Boohoo paid £3.3m for 66% of Dirty Pretty Thing. Unit economics, what are the financials for one garment's gross profit margin? What can be added in or taken out of product to come up with a unique offer for customer? How big can you realistically make gross profit margin and give great value?

Value added tax (VAT)

VAT Example:

Transaction	Cost	Cost VAT	Sale	Sale VAT	PAid to HMRC (Tax office)
Shirtmaker buys material & makes a shirt that is sold to the shop	£100	£20	£200	£40	£40 - £20 =£20
Shop buys shirt sells to customer	£20	£40	£400	£80	£80 - £40 = £40

In this example the shirt maker incurred £20 VAT when buying the shirt. This was able to be set against the VAT received from the shop and paid the difference over to HMRC. The VAT just passed through the bank account; it doesn't belong to shirt maker. This is why the VAT office take it seriously when businesses are behind with VAT, because it's not their money! The same principle applies to the shop, where the consumer ends up paying the VAT. If your business is VAT registered, you would use VAT exclusive prices when preparing business forecasts or expenditure requests.

Why cash doesn't equal profit

Toad means 'why profit doesn't = profit'. Often "finance people" and "non-financial people" don't understand each other. That is why it is called a Toad! It's to do with this:

When is a sale recorded as a sale?

- When the goods are ordered?
- When the goods are despatched and invoiced?
- When the cash is received?

In accounting terms, it is 'when goods are despatched and invoiced'.

Imagine you are a fruit seller. Buying on the wholesale market and discarding unsold fruit at the end of the day, would mean the increase in cash in your pocket is the same as profit. As soon as you start buying and selling on account, and having stock (unsold items), then profit and cash are different in the short run. This is because of the differences in timing and stages.

This is why two reports are needed. The PL matches income and expenses in the same period. The cash flow shows money going in and out of the business bank account.

The aim of the PL is to show viability and how the business is doing. Income and expenses are matched in the same period, based on activity. This is known as accruals accounting. Another example of accruals:

Imagine you are running a graphic design business and you hire a freelancer for a week at a cost of £1,000. Being a creative, they don't invoice you at the end of the month. When preparing the management accounts, this cost would be 'accrued for', or marked as 'provided', because the business had the benefit of that time. If the business waited for the invoice to come in, the first month would understate expenses, and the second overstate expenses for the month.

For clarity, the PL income is matched with the expenses incurred, creating the income irrespective of the cash timing.

You should be aware that as an approximation of cash flow, companies often use something called EBITDA. It takes EBIT and adds back depreciation and amortisation, as these are accounting entries. For example, spreading the cost of equipment/goodwill.

Working capital

Profit and cash aren't the same in the short term. This means cash gets tied up with customers and unsold goods, and the business gets the benefit of unpaid supplier bills! This is what working capital is all about. Working Capital is money tied up in debtors plus stock/WIP minus what is owed to suppliers. As a business grows, the amount of working capital required grows. Therefore, you see fast growing, profitable businesses who run out of working capital go bust. It is essential to manage working capital and plan for the increase.
To do this, every business needs a cash flow going out at least 6 - 9 months. This gives enough time to raise more working capital, such as overdrafts. Or time to address management of working capital issues, such as get cash in from customers or renegotiate payment terms with suppliers

Working capital management and measurement

Working capital management involves the below activities. To help manage these areas, you need a means of measurement. The balance owed, or cost of stock, is expressed in terms of the "number of days' worth".

- Managing Debtors: Chasing collections and not giving extended terms.
- Managing Creditors: Establishing favourable payment terms.
- Managing Stock: Not letting stock purchasing get out of control.

If a business had daily sales of £2,000 and was owed £80,000 at the end of the month, the debtor days outstanding would be 40 (£80,000 divided by £2,000). The business had 40 days' worth of sales unpaid and tied up in debtors, not in the bank.

Revenue and capital costs

Items of expenditure that are part of the day-to-day cost of running the business, are known as revenue expenditure. Expenditure on items like equipment that doesn't wear out immediately, is known as capital expenditure. This kind of expenditure on "fixed assets" has a different accounting treatment. Because of the accrual's principle, the cost of a piece of capital equipment is spread over its "useful" life. This is an accounting entry known as depreciation.

For example, the cost of a computer bought for £360 with an estimated useful life

Forecasting Sales

Forecasting sales is very difficult, especially for a new business unit.

- Break forecast down by distribution channel, look at how you reach your customers, then by product and then by volume and price.
- It’s not about conservatism and realism.
- Don’t underestimate how long it takes to build up sales.
- Acquiring customers is one of the most expensive activities.
- Also use benchmarks of reasonableness to test your sales assumptions. This includes examples from other industries selling to similar customers as yours.

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