Manage small business finances

Learner Guide

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1. Implement financial plan

1.1 – Identify financial information requirements and obtain specialist services, as required, to profitably operate the business in accordance with the business plan

By the end of this chapter, the learner should be able to:

- Identify financial information and its source.

Financial management

Financial management is the practice of properly controlling the financial performance of an organisation. It can be the key difference between success and failure.

Note that it is different to accountancy, in which financial information is recorded and turned into statements. Financial management will require you to make decisions and set the course for the business. It may include applying basic financial principles.

Financial plans may include:

- Analysis of sales by product/service, identifying where they were sold and to whom
- Cash flow estimates for each forward period
- Current financial state of the enterprise (or owner/operator)
- Estimates of profit and loss projections for each forward period
- Financial performance to date (if applicable)
- Likely return on investment
- Monthly, quarterly or annual returns
- Non-recurrent assets calculations
- Profit, turnover, capital and equity targets
- Projected profit targets, pricing strategies, margins
- Projections of likely financial results (budgeting)
- Projections, which may vary depending on the importance of such information and the stage in the life of the business
- Resources required to implement the proposed marketing and production strategies (staff, materials, plant and equipment)
- Review of financial inputs required (sources and forms of finance)

- Risks and measures to manage or minimise risks
- Working, fixed, debt and equity capital
- Working in conjunction with external consultants e.g. investment analysts, accountants, financiers.

Financial information requirements

It is important to identify the all required financial information, as it is not advisable to make decisions based on incomplete information. It will help you to make informed decisions and understand the current state of the business.

Financial information can be used to measure your success. There is a saying that you can't manage what you can't measure. For example, how would you go about raising profits if you didn't know what your current profits were?

Most financial information is also legally required to be collected and reported. Therefore, you can ensure you are complying with legislation.

Financial information may include:

- Accrual of staff leave/entitlements
- Asset management strategies
- Maintaining and deploying assets
- Asset registers
- Balance sheets
- Bookkeeping/accounting/stock/job costing records
- Business activity statements
- Business capital
- Cash book
- Cash flow forecasts
- Financial budgets
- Financial indicators, which may be short-, medium- and/or long-term
- Payroll records, superannuation entitlements
- Profit and loss statements
- Ratios for profitability, liquidity/efficiency/financial structure
- Risk management

- Statements/forecasts taxation returns including goods and services tax.

Specialist services

Various specialist services may be required to help you identify and process financial information. You may already have contact details for some of these; otherwise, you could search local ones using phone books or the Internet. Taking recommendations from friends and family also makes it easier to hire responsible ones.

Specialist services may include:

- Accountants
- Business brokers/business consultants
- Government agencies
- Industry/trade associations
- Lawyers and providers of legal advice
- Mentors
- Online gateways
- Providers of training in accounting software.

Managerial accounting

Managerial accounting aims to provide owners/managers with the information and data they need to make all decisions relating to their organisation, as well as identify any accounting problems.

Managerial accounting is important as it can help you to make decisions on profitability or operating procedures, which can later affect larger decisions like expansion, partnerships and diversifications.

All information should be stored in a business balance sheet or income statement so that it can be developed into an informed strategy.

__**Time period**__

The time period when you identify financial information and create reports will vary, but they are most likely to be monthly, quarterly or yearly. The exact timing will depend on your organisation's protocols or requirements.

With managerial accounting, reports can also be drawn up in response to requests from business owners.

For example, a business may decide to launch a marketing campaign. The owner will need to know what an appropriate budget for it is, so they will request a report into the effect on sales and cost of the campaign.

Quality of data

It is important that all financial data is objective (based in fact) and can be proven. Hunches such as "It feels like the company is earning more money" are subjective and aren't useful in financial management.

Management reports can be created from the money which then offers advice to relevant personnel. These recommendations must be based on fact.

1.2 – Produce financial budgets or projections, including cash flow estimates, as required for each forward period, and distribute to relevant people in accordance with legal requirements

By the end of this chapter, the learner should be able to:

- Defining financial budget elements.

Budgets/projections

Budgets are an important aspect of financial management. You will need to produce them at regular intervals to determine the organisation's current financial and make decisions regarding the future.

Relevant people who it should be communicated to may include:

- Family members
- Financial backers
- Franchise agency
- Owner/operator
- Partners
- Regulatory bodies
- Trade or industry associations.

Budgets and projections are used to help small business managers forecast their financial situation. Budgets and forecasts are similar, although budgets relate to a certain period (such as the following financial year) while forecasts can be made at any time. They are often used to update budgets when estimated numbers can be replaced with the real numbers, such as when the project months have occurred. Forecasts can also be used to revise budgets with more data.

Budgets are a useful tool to identify trends overtime, such as cash flow is increasing or decreasing. For this reason, you will need to closely monitor the achieved results and compare them to the budgets; are they meeting your expectations or not? What is the reason for this?

It is vital to have a conservative and realistic outlook when producing a budget. This means using data based on the most likely outcome; while this doesn't rule out good outcomes, it also prepares the organisation in case of bad outcomes. If the budget is too optimistic, it will make the organisation look as though it has performed badly, even if that isn't the case. (The owner will be then forced to explain this, which may harm confidence in the company.)

On the other hand, if a budget is too easy to achieve, it won't provide organisation for the entire organisation. Employees won't have to work hard to reach their targets, so they won't have the motivation to go the extra distance.

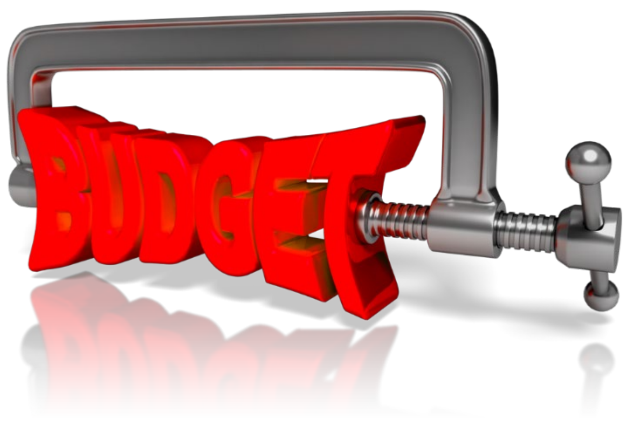
The budget will need to estimate expenditure levels based on data from previous years. They should also consider specific factors (e.g. new products, larger shop, downturn in the market) which will impact on expenses.

It is useful to get feedback from staff in your business. They will be knowledgeable about expenses and revenue in their particular area. You should also take on board any other input.

However, remember that future expenses will likely deviate from past years. You will need to make adjustments for this. For example, you may have planned for maintenance work or marketing campaigns.

The completed budget should include:

- Profit and loss summary
- Budget assumptions
- Summary of the marketing model
- Key points on revenue and expense line items
- Variances from the previous year or other periods.



Once the budget is completed and has been approved by the relevant members of staff, it should be put to use straight away. All financial decisions should be made with reference to it.

Cash flow estimates

Cash flow estimates is how much you believe your organisation will bring in during the period of the budget.

Cash flow may include:

- Anticipated payments
- Anticipated receipts
- Customer credit policy/debt recovery
- Taxation provisions.

As mentioned earlier, it is important not to be too optimistic about cash flow projection. This can lead you to increase expenses, which will reduce profits if the cash flow doesn't increase.

Example - The cash flow projection

Cash revenues	Cash disbursements	Reconciliation of cash flow
➢ Revenue from product sales ➢ Revenue from service sales ➢ Total cash revenues	➢ Cash payments to trade suppliers ➢ Management draws ➢ Salaries and wages ➢ Promotion expense paid ➢ Professional fees paid ➢ Rent/mortgage payments ➢ Insurance paid ➢ Telecommunications payments ➢ Power/utilities payments ➢ Total cash disbursements	1. Opening cash balance 2. Add: total cash revenues 3. Deduct: total cash 4. Disbursements 5. Closing cash balance

Twelve-month cash flow example

	Current	Month	Month	Month	for 12 months>>>>>>
Cash on Hand (beginning of month)		0	0	0	0
CASH RECEIPTS					
Cash Sales					

Income from accounts					
Loan/ other cash					
TOTAL CASH RECEIPTS	0	0	0	0	0
Total Cash Available (before cash out)	0	0	0	0	0
CASH PAID OUT					
Purchases					
Purchases (specify)					
Purchases (specify)					
Gross wages					
Payroll expenses (taxes, etc.)					
Outside services					
Supplies (office & other)					
Repairs & maintenance					
Advertising					
Car, delivery & travel					
Accounting & legal					
Rent					
Telephone					
Power					
Insurance					
Taxes (GST)					
Interest					
Other expenses (specify)					
Other (specify)					
Miscellaneous					

SUBTOTAL	0	0	0	0	0
Loan principal payment					
Capital purchase (specify)					
Reserve or investments					
Owners payments					
TOTAL CASH PAID OUT	0	0	0	0	0
Cash Position	0	0	0	0	0

Distribution

Once the plan is complete, it will need to be distributed to people who will be involved in implementing or monitoring it.

These people may include:

- Financial backers
- Franchise agency
- Owner/operator
- Partners
- Regulatory bodies
- Trade or industry associations

It should be provided in a timely manner and in a format they can easily understand.

Legal requirements

Every business needs to abide by compliance requirements. These made by legislation, regulatory bodies or codes of conduct. The specific requirements that will apply to your organisation will vary depending on your type of business, industry and business size/structure.

Legal requirements will include:

- **Australia Taxation Office (ATO) –** All business are required to register and pay the appropriate amount of taxes
- **Australian Competition and Consumer Commission (ACCC)** – Deals with consumer protection, ensuring companies treat them fairly, and competition between businesses
- **Australian Securities and Investments Commission (ASIC)** – Regulates Australia's corporate, markets and financial services

- **Insurance** – Companies will need to be insured for the activities that take place on their premises; this is often a legal requirement and is a good move financially.

1.3 – Negotiate, secure and manage business capital to best enable implementation of the business plan and to meet requirements of financial backers

By the end of this chapter, the learner should be able to:

- Research capital and equity capital funding, recognising advantages and disadvantage.

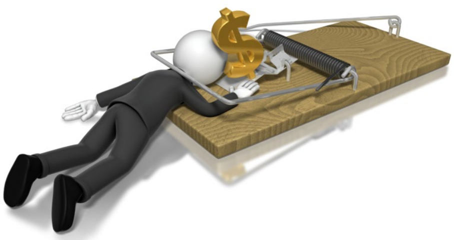
Business capital

A business' capital is all of its property, resources and assets that are used to generate income. Capital may be either physical or monetary. Without capital, businesses are unable to provide the products or services they use to make money; it is, therefore, essential to have capital at all times.

Without proper access to or management of capital, you won't be able to implement your business plan properly. You may be forced to cut costs or let staff go.

Financial backers may require that you have a certain amount of capital before they invest or lend to you. Otherwise, they may see your organisation as a risky venture with an uncertain future.

Financial backers may include:



- Financiers/banks/lending institutions
- Leasing and hire purchase financiers
- Providers of venture capital
- Shareholders/partners/owners/family/friends
- 'Angel investors' who invest in start-ups in exchange for equity.

To negotiate, secure and manage capital properly, you will need:

- A tested business model
- A tested marketing approach
- Necessary experience within the business
- Accurate estimates for required capital for the organisation to be cash flow positive
- Contingency plans for unforeseen events.

Before raising capital, you will first need to determine how much you need. Don't go too high as it will be difficult to secure it, but it is important to have enough to generate a return.

To raise capital, you should:

- Have a comprehensive plan that identifies future needs; investors will be unlikely to trust your predictions otherwise

- Constantly review your capital needs and be aware of outside influences that may change it
- Research the lending industry and understand what they look for in plans and organisations
- Look for opportunities in your local area and consider looking for capital from your target customers' demographics.

Maintaining and preserving capital will require you to continually meet the requirements of your financial backers.

Therefore, you should:

- Analyse your organisation's strengths and weaknesses and take action based on them
- Regularly review your financial plans and strategies as the market changes
- Don't be afraid or opportunities, but be aware of running out of capital
- Monitor your ability to access liquidity and cash
- Consult with key stakeholders to get their opinions of your business
- Create cash flow plans to prevent against sudden cash needs
- Manage your debt. This may include exploring options for re-negotiation and looking at other forms of liquidity

- Controlling and cutting costs, particularly in unstable economic environments. However, be careful not to erode capital or undermine your business strategy.

Optimising capital when implementing the business plan may include:

- Giving special consideration to all decisions regarding capital; don't use it wastefully
- Develop operational efficiency strategies
- Identify areas of poor asset management and capital deployment
- Use benchmarks to monitor your asset performance, both internally and externally (against competitors)
- Put plans in place so you can get more capital quickly if you need it.

(Source: http://www.investopedia.com/terms/c/capital.asp, https://www.forbes.com/sites/allbusiness/2015/02/05/20-things-all-entrepreneurs-should-know-about-angel-investors/#413fd0fec1aa)

1.4 – Develop and maintain strategies to enable adequate financial provision for taxation in accordance with legal requirements

By the end of this chapter, the learner should be able to:

- Explain methods of making provisions for taxation.

Financial provision for taxation

You will have many demands on your finances, including taxation. It is important you set aside money from your income or revenue to pay for these costs; otherwise, you may be caught out by them. While other unpaid bills like rent or salaries can result in legal action, unpaid tax can lead to you losing the business.

It is important to continually monitor cash flows, budgets and balance sheets to ensure you are making enough revenue. The amount of tax you pay each year will change depending on a variety of factors like revenue and legislation. If you don't keep monitoring your finances, you may get caught out by a large bill.

Tax requirements

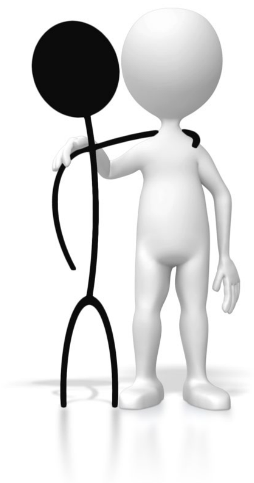
Taxation requirements vary according to the type of business.

Sole traders

Unlike organisations, sole traders are only required to declare finances from their business (either income or loss) in personal income tax returns. They also pay tax at individual tax rates.

Sole traders send their tax returns to the Australian Tax Office (ATO). The ATO will then calculate whether the individual will need to make pay-as-you-go (PAYG) instalments. Therefore, it makes financial sense for sole traders to budget for the tax they will have to pay, either by putting money aside (known as making a provision) or making voluntary payments to the ATO.

Partnership



A partnership of two or more individuals/companies submit a collective tax return but don't pay the tax together. Instead, each partner will be taxed individually. They will pay their share of the net partnership income on the appropriate tax rate.

Partners can also make PAYG instalments against their tax assessments.

Company

Companies are legal entities, unlike sole traders, and therefore have their own income tax liability. They pay income tax on their assessable income (their profits, which is calculated by subtracting costs from revenues) at the company tax rate. Companies pay tax, regardless of how much they make.

Owners, directors and office holders will also need to declare salary, wages, directors' fees and dividends on their personal tax forms. These will be subject to tax at individual tax rates.

Trust

A trust is an organisation that looks after and manages property or income on behalf of others, who are known as the beneficiaries.

Trusts don't pay tax directly; instead, the net income is distributed to the beneficiaries, who pay tax on their share at individual tax rates.

Maintaining adequate financial provision for taxation

To maintain provisions, you should:

- Make estimates of income tax liability for the following year based on data and experience
- Put aside revenue from sales or fixed assets to fulfilling income tax obligations
- Researching and making provision for all taxes, include:
  - Goods and services tax (GST), a 10% tax on all goods and services
  - income tax returns
  - fringe benefits tax returns
  - PAYG (pay as you go) withholding
  - superannuation.

To make provisions for taxation, you should debit it on the profit and loss account of your organisation's financial plan. In the future, it will be presented as a liability or can be deducted from Special Assets is it is made against a specific asset.

1.5 – Develop, monitor and maintain client credit policies, including contingencies for debtors in default, to maximise cash flow

By the end of this chapter, the learner should be able to:

- Explain their organisation's credits policies
- Identify the effects of liberal and strict credit policies.

Credit policies

Some organisations offer credit to clients. Many small businesses only use cash, although they may wish to compete with larger organisations that offer credit. If you choose to do so, you will need to develop credit policies to ensure that you are able to recover it. Otherwise, you may find your business with a constricted cash flow.

The purpose of policies is to regulate the credit and prevent your organisation from becoming over-extended. This may lead to you being able to pay your own creditors.

Credit policies may include:

- **Collateral:** A form of security (e.g. property, possessions) used to guarantee repayment. If the repayment doesn't occur, the creditor can keep them as compensation
- **Credit limits:** How much clients can borrow; the higher the limit, the more your cash flow will be restricted
- **Credit references:** People or companies that can verify clients are likely to pay back the credit they are seeking
- **Debt collection:** Methods of collecting money. Policies will range from sending letters to using professional debt collectors
- **Payment options:** Methods that the client can pay back the money. Terms will relate to amounts per month and interest.

You will need some level of formality with your credit policies. Some organisations may use specific documents, credit applications or credit checks; you will need to decide whether these are suitable to your business or will ultimately harm more than they will benefit. Small organisations may prefer to rely on instincts, although there are risks with this.

Maintaining client credit policies

You will need to consider how your credit policies affect your cash flow. Strict credit policies may lose the sales from potential customers and ultimately reduce the amount of cash inflows. However, too lax policies will lead to difficulties collecting money from customers, which will lead to revenue problems. The aim of your policies is to attract good customers without affecting your cash flow.

Your policy should include:

- Records of client's credit
- Plans and timelines to recollect from them (e.g. sending invoices and giving them 30 days to pay)
- How customers should repay you.

Your credit options and recovery plans will vary determining on your type of business and customers. For example, having dozens of customers with small debts will need to be handled differently to a few customers with large debts.

Guidelines for maintaining credit policies are:

- Establish your credit policies in relation to your cash flow needs; don't let yourself become overextended
- Build your credit facilities into your business plan
- Review and adapt credit policies; use failures to recover money as learning experiences to improve them. Always consider whether the policies are meeting yours and your clients' needs
- Make records of which customers are good client risk to improve your decision making. Introduce variable terms which offer flexible terms to those who are good risks, and less flexible ones to those who you may have difficulty with
- Take the economic conditions of the local or national market into account when setting policies
- Ensure that all staff are aware of credit policies and any changes to them. If staff offer a customer credit on incorrect terms, you won't be able to correct it afterwards. Therefore, it's important that they know them at the time.

1.6 – Select key performance indicators to enable ongoing monitoring of financial performance

By the end of this chapter, the learner should be able to:

- Identify relevant KPIs for different areas of financial performance.

Key performance indicators

In order to analyse your organisation's financial performance, you will need to choose key indicators to monitor. By gathering data on these over time, you will be able to build up a picture of various parts of the organisation's performance.

There is no correct number how many KPIs you need; however, less than four won't give you much data and more than ten will likely become overwhelming. Focus on the key areas that are important to your business.

Key performance indicators:

- Need to be those that allow you to assess progress against stated strategies
- Will be conditioned by the area in which a small business operates
- Should be relevant to your particular business.

If for some reason a KPI ceases to be relevant to your organisation (for example, you move from a physical store to online), you should change it. You should also adapt indicators as the organisation's strategies and objectives change.

KPIs that are often monitored by organisations include:

- **Stock turnover ratio:** This demonstrates how long it takes to sell particular pieces of inventory; the higher the number, the longer it takes
- **Debtors turnover ratio:** The time from sale to the collection of cash. The lower, the better, as this represents customers paying their debts quickly
- **Current ratio:** How much current assets cover current liabilities. It shows whether the organisation is able to meet its short-term obligations. The general advised rule is a ratio of 2:1; for every $1 of liabilities within the next year, you should have at least $2 of current assets to cover it
- **Debt/equity:** How much the organisation relies on external borrowing. A higher ratio shows heavy use of debts
- **Interest coverage:** The ability of the business to pay interest out of profits. Banks suggest a ratio of 3:1, meaning for every $1 of interest expense, your organisation should be earning $3 (before taxes)
- **Return on investment:** How much return the owners have after tax compared to their investment. Anything positive demonstrates that the owners have made money, negative shows they have lost money
- **Gross profit margin:** How profitable the business is and how much control it has over the cost of sales. To get data from this ratio, compare it to the organisation's history or to current industry data, if available
- **Break-even sales:** How many sales need to be made to cover expenses, without making a profit. This ratio needs to be monitored closely as it may change on a monthly basis.

Some other examples of a KPI in a small business include:

- Customer retention
- Capital expenditure
- Customer penetration
- Volume of reserves
- Sales per square foot/metre asset quality
- Expected return on new stores
- Customer satisfaction Assets under management
- Competitors

- Reserve replacement costs.

1.7 – Record and communicate financial procedures to relevant people to facilitate implementation of the business plan

By the end of this chapter, the learner should be able to:

- Communicate financial procedures to relevant people.

Recording financial procedures

It is common practice for financial procedures to be recorded, however doing it well is more difficult. You should write for a reader who doesn't know you or your organisation. Make sure you include enough detail that they could implement them properly without any guidance or information from you.

When recording financial procedures, consider:

- Have you considered all possibilities?
- Is it understandable to a stranger?
- Have you gone into sufficient detail on what to do and when?

Communicating financial procedures

Many people besides yourself will be involved in the implementation of the business plan. You therefore need to communicate to them how financial procedures should be implemented.

It may be helpful to create a template for communicating financial procedures so that everyone's information is standardised.

A template should include:

- **Context:** A short statement explaining the goal of the policies and how/when they should be applied. They are useful if the reader is unfamiliar with your organisation
- **Purpose:** The reason for the procedures (e.g. to ensure compliance with legislation, to ensure recovery of credit)

- **Scope:** Who this policy applies to, as policies will rarely cover everyone all the time. Explain when they will use it (E.g. applies to salespeople when giving credit to first be customers)
- **Financial procedures:** What employees should do to comply with the business plan
- **Procedures steps:** Clearly breakdown what employees are required to do. For each step, list:
    - what they should do

- who should do it
- how the process should be recorded

- **Process map:** A graphical way of demonstrating the procedure. It could include flowcharts or maps of responsibility
- **Performance indicators:** How employees can identify whether the procedures has been implemented properly.

Information can be communicated:

- Verbally, in meetings, presentations or one-to-one conversations
- In writing (e.g. emails, documents)
- Online.

Whichever method you choose, ensure the employees have written copies of it at the end, as they are unlikely to remember all of the specifics when they come around to applying it.

2. Monitor financial performance

2.1 – Regularly monitor and report on financial performance targets, and analyse data to establish extent to which the financial plan has been met

By the end of this chapter, the learner should be able to:

- Explain the importance of financial performance targets
- Structure reports on financial targets.

Monitoring financial performance targets

It is important to monitor the organisation's financial performance targets. These may include KPIs, which were discussed in a previous chapter. If you need further data on any issues to clarify them, you should source it from the appropriate person in the organisation.

Reporting on financial performance targets

Reports are summaries of financial information about the organisation and are used to communicate with managers or owners. It is important they have up-to-date information so they can make reasonable decisions.

Your report should include an analysis of to what extent the financial plan has been met.

Analysis of data should include:

- Analysis of sales by product/service, identifying where they were sold and to whom
- Cash flow estimates for each forward period

- Current financial state of the enterprise (or owner/operator)
- Estimates of profit and loss projections for each forward period
- Financial performance to date (if applicable)
- Likely return on investment
- Monthly, quarterly or annual returns
- Non-recurrent assets calculations
- Profit, turnover, capital and equity targets
- Projected profit targets, pricing strategies, margins

- Projections of likely financial results (budgeting)
- Projections, which may vary depending on the importance of such information and the stage in the life of the business
- Resources required to implement the proposed marketing and production strategies (staff, materials, plant and equipment)
- Review of financial inputs required (sources and forms of finance)
- Risks and measures to manage or minimise risks
- Working, fixed, debt and equity capital
- Working in conjunction with external consultants e.g. Investment analysts, accountants, financiers.

Structuring the report

Reports can include a lot of data, so you should structure them in an easy to understand way. For example, you should clearly list problems in order of severity and provide all relevant information relating to it.

Information may include:

- The issue/problem that has been identified
- The date that the issue was found
- The severity of the issue – what is its impact?
- When the will issue be resolved
- What is being done to solve it.

2.2 – Monitor marketing and operational strategies for their effects on the financial plan

By the end of this chapter, the learner should be able to:

- Monitor marketing and operational strategies
- Identify relevant marketing and operational strategies.

Monitor marketing and operational strategies

As with the financial performance targets in Chapter 2.1, you will have to monitor marketing and operational strategies. You will need to determine what their effects on the financial plan are to give you data with which you can make further decisions.

Note that marketing and operational strategies may change rapidly as the business adapts to the market; the way you monitor it should also change (such as adapting KPIs).

Marketing objectives and strategies include:

- Achieving lower costs of production and distribution than competitors
- Creating a very different product line or service so that the business becomes a class leader in the industry
- Distribution
- Pricing, presentation and display of products/services
- Product design and packaging
- Product range and mix
- Promotion and advertising
- Pursuing cost leadership and/or product differentiation within a specialist market segment
- Opportunities in marketing increase when organisations evaluate the customer base and target market of clients and customers.

KPIs may include those mentioned in previous chapters. However, to determine the effects of marketing, you may have to commission customer surveys.

Questions may include:

- Which of our marketing campaigns have you seen recently?
- Which convinced you to purchase with us?
- Were you aware of our organisation before you saw the marketing?

2.3 – Calculate and evaluate financial ratios according to own or industry benchmarks

By the end of this chapter, the learner should be able to:

- Understand and use relevant financial ratios.

Financial ratios

Financial ratios are used to help understand an organisation and its finances more effectively. Several of them have already been explained in Chapter 1.6

Financial ratios may include:

- Current ratio
- Days debtors outstanding
- Days stock on hand
- Expense percentages
- Gross profit percentage
- Liquid ratio
- Net profit percentage
- Proprietary/debt ratio
- Return on investment/return on total assets
- Staff productivity measures
- Stock turn rates.

Analysis of ratios provides of a range of benefits for your organisation, including helping you to identify its strengths and weaknesses, understand its position and anticipate risks. However, they aren't definitive, and they are only as useful as the data you use to calculate them. If the data is flawed, so will the ratio. You also need to be careful how you apply ratios and consider whether they are relevant.

The major types of financial ratios traditionally used for evaluation include:

- Income
- Profitability
- Liquidity
- Working capital
- Bankruptcy
- Long-term analysis

- Coverage
- Leverage.

Area	Typical Ratio
Income Ratios	Turnover of Total Operating Assets **Net Sales = Turnover of Total Operating Assets Ratio** Total Operating Assets* Obviously, an increase in sales will necessitate more operating assets at some point (sales may rise without additional investment within a given range, however); conversely, an inadequate sales volume may call for reduced investment. Turnover of Total Operating Assets or sales to investment in total operating assets tracks over-investment in operating assets. *Total operating assets = total assets - (long-term investments + intangible assets) Note: This ratio does not measure profitability. Remember, over-investment may result in a lack of adequate profits.
	Net Sales to Tangible Net Worth **Net Sales = Net Sales to Tangible Net Worth Ratio** Tangible Net Worth* This ratio indicates whether your investment in the business is adequately proportionate to your sales volume. It may also uncover potential credit or management problems, usually called "overtrading" and "undertrading." Overtrading, or excessive sales volume transacted on a thin margin of investment, presents a potential problem with creditors. Overtrading can come from considerable management skill, but outside creditors must furnish more funds to carry on daily operations. *Tangible Net Worth = owner's equity - intangible assets
	Operating Income to Net Sales Ratio **Operating Income = Operating Income to Net Sales Ratio** Net Sales This ratio reveals the profitability of sales resulting from regular business as well as buying, selling, and manufacturing operations. Note: Operating income derives from ordinary business operations and excludes other revenue (losses), extraordinary items, interest on long-term obligations, and income taxes.
Profitability Ratios	Closely linked with income ratios are profitability ratios, which shed light upon the overall effectiveness of management regarding the returns generated on sales and investment. Gross Profit on Net Sales

	Net Sales - Cost of Goods Sold = Gross Profit on Net Sales Ratio Net Sales Does your average mark-up on goods normally cover your expenses, and therefore result in a profit? This ratio will tell you. If your gross profit rate is continually lower than your average margin, something is wrong! Be on the lookout for downward trends in your gross profit rate. This is a sign of future problems for your bottom line. Note: This percentage rate can — and will — vary greatly from business to business, even those within the same industry. Sales, location, size of operations, and intensity of competition are all factors that can affect the gross profit rate.
Liquidity Ratios	While liquidity ratios are most helpful for short-term creditors/suppliers and bankers, they are also important to financial managers who must meet obligations to suppliers of credit and various government agencies. A complete liquidity ratio analysis can help uncover weaknesses in the financial position of your business. Current Ratio **Current Assets*= Current Ratio** Current Liabilities* Popular since the turn of the century, this test of solvency balances your current assets against your current liabilities. The current ratio will disclose balance sheet changes that net working capital will not. ***Current Assets = net of contingent liabilities on notes receivable** ***Current Liabilities = all debt due within one year of statement data** Note: The current ratio reveals your business's ability to meet its current obligations. It should be supplemented with the other ratios listed below, however.
	Receivables Turnover **Total Credit Sales = Receivables Turnover Ratio** Average Receivables Owing Another indicator of liquidity, Receivables Turnover Ratio can also indicate management's efficiency in employing those funds invested in receivables. Net credit sales, while preferable, may be replaced in the formula with net total sales for an industry-wide comparison. Note: Closely monitoring this ratio on a monthly or quarterly basis can quickly underscore any change in collections.

Long-Term Analysis	Current Assets to Total Debt **Current Assets = Current Assets to Total Debt Ratio** Current + Long-Term Debt This ratio determines the degree of protection linked to short- and long-term debt. More net working capital protects short-term creditors. Note: A high ratio (significantly above 100 percent) shows that if liquidation losses on current assets are not excessive, long-range debtors can be paid in full out of working capital.
	Total Debt to Net Worth **Current + Deferred Debt = Total Debt to Net Worth Ratio** Tangible Net Worth Rarely should your business's total liabilities exceed its tangible net worth. If it does, creditors assume more risk than stockholders. A business handicapped with heavy interest charges will likely lose out to its better-financed competitors.

Content retrieved from sources: Analyzing Your Financial Ratios - Td Bank, http://www.tdbank.com/small_business/workshops/Ratios/textratio_analysis.htm *and* Analyzing Your Financial Ratios | Small Business Center .., https://www.bbt.com/business/small-business-resource-center/growing-a-business/f *and* Analyzing Your Financial Ratios - University Of Alaska .., https://seagrant.uaf.edu/map/workshops/2008/business/fishing/handouts/financialr (accessed August 02, 2017)

Benchmarking

Benchmarking is the practice of setting standards for your organisation's performance. They may be industry standards (such as the 2:1 current ratio mentioned in Chapter 1.6), competitor's standards or your organisation's individual standards. They can be used to measure how the organisation is faring and identify best practice.

Benchmarking can be used to learn from competitors by asking:

- What is their profit?
- What is their return on interest?
- How do their products/services compare to yours?

This can help you to question your own practices and identify methods of improving operations.

As mentioned, benchmarks can be compared to your organisation's previous performance. For example, if the current ratio falls from 2.2:1 to 2.1:1 to 1.8:1, you would need to investigate why it was falling and how to reverse it.

It is also important to record the benchmark data for future analysis. This will help you to identify long-term trends.

2.4 – Assess financial plan to determine whether variations or alternative plans are needed, and change as required

By the end of this chapter, the learner should be able to:

- Explain how to assess profit and loss/cash flow budgets.

Assessing the financial plan

Business plans are never complete, and you will need to keep assessing them to determine whether variations or alternative plans are needed.

Variations or alternative may be needed if:

- The organisation changes significantly in size, structure, service/products or any other way
- Information or contingencies were omitted from the initial financial plan
- National or local economy/market changes significantly (e.g. recessions, periods of growth, increase in competitors)
- The organisation's goals change
- The organisation's financial position changes (e.g. rise/loss of revenue or costs).

Profit & loss and cash flow budgets

Profit and loss and cash flow budgets are used to collate financial information and provide a comprehensive overviewing incomings/outgoings. These is particularly important for manufacturers, wholesalers and retailers.

Income and expenses may either include GST (goods and service tax) or not. The profit and loss budget should include separate columns to distinguish between them.

It would be helpful for the cash flow budget to automatically calculate GST owed so that provision can be made for them. (This could be done either monthly or quarterly, depending on when it is paid.) GST may be paid on either a cash or accrual basis, which the budget should reflect.

Operating expenses on the profit/loss budget are often amortised (gradually written off) during the 12-month period.

Stock control

The purpose of stock control is having the right balance of it. Too many, and your organisation's assets are tied up in products that may become outdated and need to be stored or maintained. Too little stock, you will find it difficult to keep up with demand and generate revenue. This could also lead to higher shipping costs, as you will constantly have to restock.

Contingency plans

Organisations should have contingency plans in place to deal with unexpected events. This will give you a rough guide on how to respond while you work out the specifics. Each possible event will have a risk level, showing how serious a problem it is to the organisation.

Risk	Risk level	Contingency
Website stops working	Low	➢ Contact customer support ➢ Take orders over the phone until resolved
Fire destroys stock	Medium	➢ Claim on insurance for destroyed stock ➢ Carry out risk assessment for remaining building
Customers decrease due to recession	High	➢ Invest in free marketing (e.g. social media) ➢ Review pricing strategy.

References

These suggested references are for further reading and do not necessarily represent the contents of this unit.

Websites

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All references accessed on and correct as of 12th July 2017, unless other otherwise stated.