Figure it out

An entrepreneurs' guide to understanding your business numbers

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Contents

Introduction

If you have picked up or downloaded this book then you probably run your own business or are planning to do so in the near future. You are probably also one of the 96% of businesses that employs less than 5 people and the 91% of businesses where the owner is the primary marketer. Given everything else you have to do you are short of time….. so short of time in fact that you may have given little thought to your bookkeeping and accounts or you are planning to give it all to an accountant – when you get round to finding one – and in the meantime, you hope that enough cash comes in each month to pay the bills and leave something over for you.

We bet that wasn't the plan when you gave up your job to run your own business. Just as working 50-60 hours a week and not seeming to get any time off wasn't part of the plan.

Fortunately it doesn't need to be like that, but you will need to make a few changes. And one of the first is to get a good accounting system installed to produce your business numbers. We call them *business numbers* and not accounts for a reason. You see *accounts* conjures up in most peoples mind the figures the accountant prepares at the end of the year (usually well after the end of the year!) to work out how much tax you owe and to send to HMRC. We mean something completely different as we'll show you.

Anyone running or involved in a business should know the financial state of the business on a regular basis, but more importantly should be able to use the financial information about the business to manage it more effectively, increase revenues, save costs and take important strategic decisions about the direction the business should take.

But unfortunately too many business owners fail to get the most out of the financial information available to them: some are genuinely afraid of the 'money' side of the business, others – often those with a creative background – find numbers confusing, and most have been conditioned into thinking it is all too complicated.

Some will go to their accountant – armed with the knowledge in this book – and say 'I need to know these things, will you help me?' You will get different responses here. Some of them will look at you like you are a little mad because 'that's not what they do' and they don't *get* marketing. Plenty will tell you 'You don't need all this; it's too complicated for your business.'

Don't be put off, because understanding your business numbers – when they are produced properly – is what frees your time to be able to do the right things and spend the right amount of money on the right things to develop and grow your business.

At the end of some of the chapters you will find a series of exercises; try and complete these as you go rather than put them off. Now we have set the scene, let's start to look at why numbers matter.

Chapter One

Why numbers atter

To begin with, we want to explain what we mean by being the *primary marketer* in your business. It may seem unusual in a book about numbers to start by talking about marketing but it shouldn't be as we'll also show you. First, we need to establish two important principles…..in fact probably *the* two most important principles involved in running your own business.

1. What is the most valuable asset in your business?

The answer is your database. Whether it is a list of names and telephone numbers of customers or a sophisticated customer relationship marketing (CRM) system, it is by far your most valuable asset. I love it when my competitors say 'My people are my most important asset' because they haven't got their eye on what matters most, which is building your customer database.

2. What is the most important thing you do in the business?

And the answer to that is getting and keeping customers – or marketing – because without them there is no business.

These two principles are what will drive your business growth. And if they are so important shouldn't you measure them and the results they give? And not just the results but the time and costs involved. Of course you should. But it doesn't need to be complicated.

Many accountants, even the ones who get marketing, surround what they do with jargon and a mystique it doesn't justify. It is largely straightforward and common sense. Most of the time all they do is add and subtract! With a little practice anyone can do it, although we do recommend you get a *really good accountant*, because as your business grows it is invaluable having someone who can help you analyse and interpret your numbers.

And it needn't cost a great deal. A properly designed accounting system, which enables a large amount of valuable financial information about the business to be produced on a weekly, monthly, quarterly and annual basis and then analysed to provide input to strategic decision making will pay for itself many times over. You choose the financial information you want and one of the many 'off the shelf' accounting software packages will do all the hard work.

But we are getting ahead of ourselves. First we need to know what numbers we need and what they mean – all with as little jargon as possible.

Exercise
Database: What sort of database do you have? How often do you contact your 'list'? Accountant: Do you have a really good accountant? If not, plan when you will find someone. Numbers: Do you know what the key numbers you need to measure in your business are?
Accounting system: Have you got a system for producing weekly and monthly numbers?

Chapter two
Profit

The first and *almost* the most important number you need to know is your profit, because that is what most people looking at accounts turn to first. It will be in something called the *profit and loss account (P&L)*, *income statement* or will be called something like that and shows the difference between income and costs during a reporting period such as a week, month, quarter or year. Sarah calls it the 'Where am I against target' statement. It'll look something like this:

Where am I against target statement Five months to 31st August 2014			
	Actual	Budget	Variance
Sales	27,800	30,000	(2,200)
Minus Cost of sales	(19,600)	(20,000)	400
= Gross profit	8,200	10,000	(1800)
Minus Overheads	(5,400)	(6,000)	600
= Net profit	2,800	4,000	(1,200)
Less tax	(560)	(800)	240
= Retained profit	2,240	3,200	(960)
Gross margin	*29%*	*33%*	
Net margin	*10%*	*13%*	

The statement shows both actual and budgeted figures: many times we hear from the owners of small businesses that they cannot prepare a budget. That frankly is nonsense. Every business can and should prepare a budget for the next twelve months.

Secondly a tax charge is included – not because it has been paid, or is even payable for many months, but because it has to be paid sometime and so it should be accounted for now (and ideally put away in a separate bank account so it isn't spent!) And lastly we have calculated the gross and net margin figures, which every business should know.

In practice sales and gross profit should be analysed by customer and by product so that strategic decisions can be taken about which products to invest in and which customers are too much trouble!

This statement shows the performance for five months; in practice we suggest you have a weekly statement for sales and cost of sales and overheads because if things are going wrong or your costs are increasing faster than your sales, waiting a month to find out is a long time. And if there is a problem and you understand why, then you can take action to rectify it.

And finally, key numbers you should know are what level of sales you need each week and each month in order to break even. Your break-even point = Sales minus (costs + expenses). If you sell more, then you make a profit. On the other hand, if you sell less then you make a loss. And surprisingly, even though it is relatively simple to calculate, few business owners know their break- even point. However, if you can measure your sales and costs, conducting a break-even analysis is a matter of simple maths.

Exercise

Budget: Have you prepared an annual budget? Start now with a monthly sales forecast.

Profit: Do you measure your weekly and monthly profit? How can you do so in future?

Analysis:Doyouhaveasystemforanalysingyoursalesandgrossprofitbycustomerandproduct?

Overheads: Do you measure your overheads every month?

Tax:Doyouknowhowmuchtaxyouoweandwhenitispayable?Arethesefiguresinyourcash flow forecast? (see Chapter 3)

Break-even: Calculate your break even sales. Are you operating above this level?

Chapter three
Cash

The next number – and this *is* the most important - to look at is cash flow or as Sarah calls it the 'Can I pay the bills statement'; fortunately this one is the easiest to understand because it does what it says. It measures the cash that has flowed into and out of the business during a period of time.

Big point: cash inflow is not the same as the profit you have made. In fact you can make a profit and still have negative cash flow! If that seems perverse consider this: the profit and loss account shows sales *whether or not you have been paid*, whereas the statement of cash flow shows the cash received only when the customer pays. You cannot spend profit….only cash.

This is why in most small businesses cash is more important, at least in the short term, than profit and why many early stage businesses need the owners to put money in or to borrow from family, friends or the bank.

It also highlights the importance of keeping a very watchful eye on the amount of credit (called debtors) you give to customers. If you can – like a retail shop or restaurant – you should only sell your products or services for cash or take payment upfront. But that isn't always possible, so if you have to give credit follow these six rules:

i. Check the credit worthiness of the customer (Your Business HQ can help with this) and set a credit limit;
ii. Invoice promptly – don't wait until month end;
iii. Make it easy for customers to pay (tell them how, when, and consider setting them up on a Direct Debit so that they don't need to do anything and you are in control of when payment in taken – we use an affordable system called GoCardless);
iv. Don't supply customers who abuse your credit terms;
v. Make sure your accounting system produces regular information on overdue amounts;
vi. Have a system for following up as soon as the debt is due.

Now calculate how many days sales are tied up in Debtors (called Debtor days) by taking the latest months sales (+VAT if applicable) and comparing it to debtors; if there are some debtors left over go back another month and so on. 30-45 is alright if you allow credit. Over 60 is too high.

Unfortunately most accounting software packages do not automatically produce a cash flow statement; however it is easy to set up a template to produce one and it should be part of your month-end reporting.

And before we leave cash, you must have a cash flow forecast – even a basic one. Most businesses work under some cash pressure…often self-imposed to keep them lean…and so a cashflow forecast is essential to know how much is there, what's coming in and how much can go out. It'll probably look something like this:

Can I pay the bills this year -2014												
	Jan	Feb	Mar	Apr	May	June	July	Aug	Sept	Oct	Nov	Dec
Cash in												
Sales Bank												
loan												
Cash out												
Purchases												
Expenses												
Wages												
VAT												
HP												
Tax												
Drawings												
Net cash flow												
Opening cash												
Closing cash												

Exercise
Cash forecast: Prepare a cash flow forecast for the next six months (if you are VAT registered don't forget to include VAT!)
Debtors: Prepare a list of outstanding debtors and calculate your debtor days

Chapter four

Thecostofbuildingyourdatabase

We saw earlier that the most valuable asset in your business is your database. So you should know how much it is costing. Would you buy a car without knowing how much it cost? Of course not! So treat your most valuable asset the same way and understand the cost of building your database….or put another way the cost of generating leads. This starts to get really important if you have multiple lead generating sources (or marketing pillars as they are sometimes called) and you start to break down your costs by each source.

For example if you run a website, use pay-per-click and advertise in a local newspaper you have three lead generating sources; if you measure the cost of each and the leads generated by each source you can calculate your cost-per-lead-per source.

It is also important to know which bits of your marketing are generating leads. For example if you use tracking numbers on, say, your flyers, business cards and an advertisement and you know how many leads each generates then you can measure your cost per lead.

Once you start to know these numbers you can decide where to invest to maximise how much you spend in the area where your cost to get a lead is lowest. Does that make sense?

The cost of converting leads

Well sort of. Of course you want leads, but you really want those leads to turn into customers. They become a customer when they spent some money, but not all leads become customers. So next you need to know what it costs you to convert a lead to a new customer and how many leads convert to customers, or what is called 'conversion rate'.

Simply put, a conversion is the moment you've been waiting for. Conversion is when curiosity morphs into commitment. Your conversion rate is the percentage of leads you convert into customers and the higher the percentage, of course, the better.

Conversion rates are important because you have already put a lot of effort and money into drawing potential customers to your site. The energy and funds you've invested are a necessary (perhaps painful) cost. Once this effort has drawn a crowd of curious onlookers, you have everything to gain by converting as many as possible.

Since you've already spent money attracting people to your site, each conversion pushes your cost-per-customer down. Put another way, when you increase your conversion rate by, say, 100% you're getting twice the customers for the same advertising budget.

Big point: when you convert one lead, you have not only gained their business, you have ended their consideration process. *They're now much less likely to be looking to your competitors for what they want.* After all, the whole exercise of weighing options can cause fatigue.

If you've ever stood in front of 20 flat screen TVs at your local electronics store and secretly wished someone would just make the decision for you—you know the anxiety that comes with too many options. Your new customer may well be relieved to have made a decision; now you can confirm their choice by providing a good product or service.

But boosting your conversion rate isn't easy. It takes hard work and persistence. The work, however, is worth it. No matter how gloomy the outlook may be, there are things you can do to improve your conversion rate. If they're on your website, they're in consideration mode; all they may need is a little push.

Exercise

Lead sources: write down each of your lead generating sources: there may be more than you think! No. of leads: how many leads have you generated from each source in the last month, quarter and year?

Cost per lead: how much have you spent on each source in the last month, quarter and year. If you don't know, start to keep a record. Now calculate your cost per lead.

Conversion rate: how many customers have you converted from leads/ how many from each source?

Boost your conversion rate: Write down three things you are going to do to increase your number of leads and three things to boost your conversion rate.

Chapter 5

Customer lifetime value

Once you have a customer there are two key metrics you should measure: how much they spend in their first 90 days and how much they are worth over their lifetime.

The first is easy…in 90 days you'll know….but the point is as you track each new customer and spot trends you can tell how much it is worth investing in each customer to get additional sales. It also tends to be the case that if you offer a new customer an add-on or upsell they will be more likely to take it when they are making their first purchase or shortly thereafter.

The second question is harder, which is why you should measure the *average* lifetime value of a customer to your business. Go back to when your business started….or just 3 years if that is easier…and take the total sales you have made and the number of customers it has taken to achieve those sales. So if your sales in three years were £1.5m and you had 500 customers, then your average lifetime value, over three years, is £3,000.

Knowing this figure opens up all sorts of possibilities. Think about it. How much would you be prepared to spend to get a new customer: £10? £100? £1,000? Well if the customer was going to be worth £3,000 it may be more than you thought at first.

Now, of course, some customers will spend more and some less, but knowing the *average* number allows you to think differently about your marketing spend. And that spend may not be money, but giving something for free, particularly if it looks as if you are bonkers to do it!

And unlike some of the other numbers we've talked about, customer lifetime value is one of the easiest to calculate…and yet it amazes me how few businesses know it.

Exercise
Calculate how much your customers spend in their first 90 days; which upsells work and why?
Calculate the lifetime value of your customers by taking the total sales you have made and the number of customers it has taken to achieve those sales.
Now, how much can you spend to get a new customer?
Devise a new marketing strategy to spend that amount (PPC, advertisement) and measure how many new customers it generates.

Chapter 6 Customers and products

In Chapter 2 we said that sales and gross profit should be analysed by customer and by product so that strategic decisions can be taken about which products to invest in and which customers are too much trouble!

How profitable are your customers? It's relatively easy to measure sales by customer but of course without knowing how profitable they are the number is meaningless. It's all very well knowing that 500 customers in my example brought in £3,000 per customer, but what was the profit on that? The way to find out goes something like this:

Firstly, every sale will have a cost to produce, buy or service which is called cost of sales. This may be made up of materials, bought in product and time. These need to be calculated for every product. Fortunately there is a popular method of costing called standard costing for calculating the *expected costs* of production. It works by establishing a detailed standard cost for each component of a product, the direct labour required to make it and the apportionment of fixed overheads (by dividing the total fixed overheads by the expected number of units to be produced) to arrive at the total standard costs for one unit of output.

But standard costing has another valuable role to play and that is in determining the cost of the items sold during a period – the exact figure you need. And not only can it determine that figure in total for the period, but it can determine it for each product that is sold! This is why every business should have a costing system. Not only does it tell you how much to expect it to cost to make/produce/assemble every item you sell, but it will also enable you to calculate the profit on each item without having to count and value stock every month. In fact armed with this information you can calculate your daily or weekly gross profit which many successful businesses do.

Making informed decisions

But now imagine what is possible. With only a little more work you can produce not only an analysis of sales by customer/by product but also gross margin by customer/by product. This will tell you who your most profitable customers and products are and should also raise a host of other questions about your business which will help you drive your marketing strategy.

Secondly, every customer will have a cost associated with acquiring them in the first place, servicing them after they have bought, collecting what they owe you and so on. Most of these costs are hidden in your overheads and are not analysed separately by customer. So what you need to do is identify the *average customer service cost* in your business and deduct this from the gross profit of each customer to arrive at a profit per customer. More on this in chapter 7.

We recognise that this is where you may need help to get these numbers from your *really good accountant,* but once they have set up a system to produce them, it should be relatively easy for your bookkeeper to replicate it each month.

Exercise Sales: do you measure sales by customer and by product? If not start doing so. Costing system: do you have a costing system that tells you the cost of each product or service you sell? If not start to calculate your product costs, contact your accountant or visit our website. Calculate your gross margin by customer and by product: who are your most profitable customers? Do they get your best service (not all customers are equal!) How can you reward them?

Chapter 7
Controlling costs

Costs which are not directly related to making/producing/assembling the product or service you sell to your customers are generally called overheads. In a typical manufacturing business these costs account for up to 25% of revenues and an even higher proportion in service based businesses.

And yet a significant proportion of these costs are unnecessary and wasted. Numerous studies have determined that between 15-25% of the costs in a manufacturing business are wasted, and that for a typical service company somewhere between one-quarter and one-third of its annual budget is spent on work that is of poor quality or irrelevant to the customer. Much of this is rework but because it is often masked as 'real' work it is very difficult to quantify.

But if those studies are correct, that in itself presents an interesting strategic dilemma for your business. Before you go chasing more customers or more business from existing customers, should you look at your systems and processes to eliminate the waste? If you don't will you just be putting more volume through an inefficient system? If instead you focus on eliminating unnecessary costs and waste you may make a bigger, more immediate impact on the bottom line.

Eliminating unnecessary work and wasted costs is not easy and is not helped by accountants who measure costs in terms of salaries and wages rather than in terms of the work people actually do. The key to changing this is to find out exactly what people do, how well they do it and how relevant it is to the customer. By looking at overheads in this way can you identify how much adds value and how much is wasted. We recommend that costs should be analysed under three headings: sales and marketing, administration and occupancy.

1. Sales and Marketing

   The sales and marketing costs in a business are those directly related to obtaining new customers, generating orders from new and existing customers, ensuring those orders are fulfilled, and following up to ensure the customer is satisfied and will place future orders.

   But as we shall see (and as is the case with all costs) there is a distinction to be drawn between productive and non-productive costs. The problem for you as the business owner is that this distinction is hard to draw.

   There is a saying, attributed to John Wanamaker, that "Half the money I spend on advertising is wasted; the trouble is I don't know which half." That of course is no longer, or should no longer, be the case with the ability to split test marketing campaigns, measure online marketing using analytics and so on. But how productive is every hour a salesperson spends visiting customers, how often does an order go astray and need chasing and how many hours are wasted in meetings?

We propose an analysis of your sale and marketing overheads that goes beyond the usual information in your management accounts. Let me give you an example.

A computer software business has three sales people costing (including salaries, bonuses, travelling, benefits etc.) £300,000 per annum. The sales manager has asked for an extra sales person to meet the sales budget but the owner isn't so sure. He asks for an analysis of the activity of each of the existing sales people to be conducted over a month with the following result:

Sales costs (£000s)

Activity	Productive	Unproductive	Total
Visiting customers	80	0	80
Travelling	40	20	60
Processing orders	20	0	20
Reprocessing orders	0	30	30
Checking prices	5	5	10
Chasing warehouse	0	20	20
Attending meetings	50	30	80
Totals	195	105	300

So not only does the business *not* need another salesperson, in fact almost one-third of the current activity is non-productive.

This example obviously requires different numbers to be produced than is typically done by accountants, but this is not difficult to do if the focus is on people (activity) and processes.

Sales and marketing overheads are typically analysed into categories such as advertising, brochures, website, samples and so on. But these descriptions are rarely useful and have often been chosen because they are easy to define.

We advocate a more meaningful analysis of sales and marketing overheads that will aid decision making and shape your strategy. How different would your business look if you analysed your sales and marketing overheads into categories such as:

- researching customer needs
- acquisition of a new customer
- obtaining a customer order

- processing a customer order
- providing customer service

Initially this may seem difficult and require some arbitrary allocation of costs, but once a system is established it should be no more difficult than your existing analysis. What it will do, however, is focus attention on the actual costs involved in, say, acquiring each new customer and identify those costs which do not contribute to revenue or profit.

And if you have carried out the exercise we recommended in Chapter 5 to work out the lifetime value your customers you will need to know your customer service costs.

2. Administration costs

Not unlike sales and marketing costs, administration costs tend to be people based but administration costs are more difficult to associate with what is relevant to the customer. They tend to be thought of as 'the things we just have to do' but if that is the case they must be done for a reason. That is why we advocate analysing once again the activity and relating it to a customer need. Then it is a cost which can be absorbed directly into the customer activity.

Let me explain. Someone is doing the administration and if you analyse what they do it might look something like:

- managing supplier, obtaining quotations and paying bills;
- managing payroll: sales staff 25%/factory 65%/admin10%;
- sales analysis and collecting customer debts.

Each of these activities can be allocated and absorbed into a cost elsewhere. Any unallocated costs can then be scrutinised to see if they are really necessary

3. Occupancy costs

Occupancy costs relate to the costs of occupying your business premises and include rent, rates, insurance, utilities, depreciation, maintenance and repairs. They are often seen as fixed costs that you can do nothing but pay! While this may well be true there are always questions you should ask about all your costs. When it comes to occupancy these include:

1. Do you really need premises at all? Could you and your staff work from home?
2. Do you need all the space you currently occupy? Can you reduce it by hot-desking?
3. Can you sublet unused space?
4. Are you using technology to maximise remote working?
5. Are you using the cubic capacity to the full?

6. How much 'luxury' space are you paying for – reception/boardroom?
7. Can you reduce the amount of stock you hold?

So controlling costs may need a bit more work on the numbers but should pay dividends…preferably to the business owner.

Exercise Do you measure your overheads every month? Analyse your overheads into sales and marketing, administration and occupancy for last month/year. Analyse the activities your staff carry out; are these all productive? If not where can you cut costs? Calculate the your customer service costs over a month and a year Are all your occupancy costs necessary? How could you save 20% if you had to.

Chapter 8
Taxation

A book about your business numbers would not be complete without a chapter on tax, as no matter how small your business is, you will be involved with tax at some level. We'll start by looking at the different type of tax, how business profits are taxed and then how you file tax returns.

There are basically three types of tax which businesses may have to collect and/or pay:

1. VAT, which isn't a tax on business at all, but is collected by businesses on behalf of HMRC;
2. PAYE & national insurance, which again isn't a tax on businesses except for the employers element of national insurance; and
3. Income tax (or corporation tax if you trade as a limited company) which is a tax on business profits.

VAT

VAT is a tax that *some* businesses have to charge and collect from their customers and pay on their sales. It is only some, because a business only has to pay VAT if it is registered with HM Customs & Revenue (HMRC) for VAT and it only has to register if it's total VATable sales exceed a limit set each year by HMRC. You must register for VAT if your VAT taxable turnover for the previous 12 months is more than £79,000*. This figure is known as the VAT registration threshold. The threshold changes - usually once a year announced in the Budget - so you should regularly check your turnover against the current threshold. You also have to register if your sales are going to go over the limit in the next 30 days.

If your business is registered you have to charge VAT on your sales and are entitled to claim back some of the VAT you pay your suppliers

It is also possible to voluntarily register. Whether this is worthwhile depends on who you customers are. If they are largely VAT registered themselves (and can therefore claim back the VAT you charge them) then you should voluntarily register so you can claim back the VAT you incur. If your customers are smaller businesses or the public you won't want to register as this will make your bills higher.

If you are registered (which is best done online at *www.hmrc.gov.uk/vat/start/register*) there are some rules you have to follow:

i) You have to complete a quarterly online VAT return
ii) Your invoices must be in a prescribed format
iii) Not all VAT you pay to your suppliers can be reclaimed
iv) You must get a proper VAT receipt from your suppliers to reclaim VAT

v) HMRC also have the right to inspect your books to making sure you are doing everything correctly.

To start with we suggest that you check with your accountant, (or you can ring HMRC's helpline *0845 010 9000) if you are unsure about what you can reclaim. Most accounting software has a VAT module which will produce your VAT return and back-up report for you and some even link to the HMRC's site so you can file online from your accounting software.

VAT returns should be filed quarterly (there is an annual scheme but I've never known anyone use it as you still have to pay quarterly) and you can choose your quarter ends. It'll make your life easier if you make your VAT quarters coincide with your accounting year end.

You must file your VAT return and pay within a month of the quarter end (you get an extra 7 days if you do both online). In order to file online you must register with HMRC to do so – which isn't the same as registering your business for VAT.

To complicate matters further there are 3 different ways you can calculate the amount of VAT you owe; the variations are intended by HMRC, bless them, to make life easier for businesses:

i) Standard accounting scheme

This is almost certainly the same system you'll be using for your accounts, which is to record all your sales and purchases as they are made regardless of whether your customers have paid you or you have paid your suppliers. For many businesses this is the scheme they will use, but if your customers don't always pay you immediately, you may be better on the next scheme.

ii) Cash accounting scheme

If you are on this scheme you only pay VAT to HMRC when your customers have paid you, and you can only reclaim VAT when you have actually paid your suppliers. Your sales must be under a certain limit (*currently £1.35m). Most accounting packages have an option to calculate VAT on either the standard or cash accounting schemes.

iii) Flat rate scheme

This scheme, which is only applicable to businesses making sales of less than £150,000, charges VAT at a certain percentage (flat rate) of your *gross* sales. The rates depend on what your business does and are laid down by HMRC who designed the scheme to save small businesses time, although we doubt whether it does that because you still have to add up everything for your accounts. In some cases it may save you money, particularly if the main cost in your business is labour or your own time. It is also possible to combine the flat rate and cash accounting schemes.

When you have registered keep the letters from HMRC giving you your unique number and registration date as you may need to refer to these in the future.

PAYE

PAYE is a tax that will only impact your business if you are a director of a company or you employ staff. If you are self-employed and do not employ anyone you can skip this section.

If PAYE applies to your business you must register with HMRC who will provide you with an Employers reference; you are then responsible for deducting PAYE and employees national insurance from your staff and accounting for the amount you have deducted under a scheme (introduced in 2013) called RTI (real time information) and paying the amount you have deducted, together with employers national insurance (the bit that costs the business money), by the 19th of the following month.

In practice it is rarely worth managing your own payroll and PAYE unless you employ 10 or more staff and even much larger businesses outsource this function to specialist payroll bureaux. These bureaux are handling many different payment situations such as statutory sick pay, maternity pay, student loan deductions, holiday pay and other statutory deductions and so have the experience to deal with the complexity of payroll. We recommend that you do so as well; the cost is usually a fraction of the cost of the salaries and wages, not to mention the cost of making a mistake! Even if you have a bookkeeper, unless they are experienced in this area it is one of the first you should outsource.

Tax on profits

Profits are taxed either as income tax (on sole traders and partnerships) or corporation tax on limited companies. There is a type of entity called a limited liability partnership (LLP) which has its own rules but is outside the scope of the book. The vast majority of business, therefore, will fall into the categories of sole trader, partnership or limited company.

Tax on profits is one of the areas in which we recommend consulting an accountant, at least at the outset. The basic rule is very simple: tax is payable on the difference between your sales and your costs/expenses, but the detailed rules are highly complex and change frequently.
Allowances can also be given against tax if you buy equipment such as computers, build a website or work from home.

Completing tax returns

If you are in business whatever structure you use, you personally will have to complete a self-assessment return for each tax year, which must be filed no later than 31st January of the following year. For directors of limited companies this will include their salary and dividends from the company for that tax year and for sole traders and partners it will include their share of profits before drawings.

A limited company is the only type of entity which pays its own tax and to do this it must file a corporation tax return. Corporation tax is payable 9 months after the company's year-end although the tax return itself doesn't have to be filed until 12 months after the company's year-end!

If your year end is 31st March and you are registered for VAT it pays to manage your cash flow carefully as in the following January you may have to pay corporation tax, income tax (on your salary and dividends) and VAT.

<u>What is the best structure for me?</u>

Whilst you should always consider which structure best suits your business from a commercial viewpoint and not let the 'tax tail wag the commercial dog', there are some general rules regarding tax that may make one structure preferable to another.

Without going into the technicalities, and again this is an area where we suggest an accountant is consulted, if you pay yourself more than £15,000 per annum you will, everything else being equal, pay less tax if you are a director of a limited company than if you are a sole trader or partner.

In summary, the UK tax system is very complex and we cannot emphasise enough that we recommend you appoint an accountant to file your tax returns particularly if you are a limited company.

* *Correct as at the time of writing this book (February 2014)*

Exercise
Structure: Have you considered which business structure suits you best from a tax viewpoint?
VAT: Are your VATable sales above the VAT threshold and if so have your registered for VAT? PAYE: Are you a company director or do you employ staff: if so you need to register as an employer for PAYE purposes.
Self-assessment: Have you registered with HMRC and told them you need to complete a self- assessment tax return?
Tax returns: Make a calendar to show when your tax returns and payments are due.
Accountant: Set aside some time to find a really good accountant to keep you on the right side of HMRC!

Chapter 9 Pulling it all together

Well ok, we do mean *management accounts,* but if we'd called it that you'd probably have skipped this chapter and gone to the pub, hence…

But's let be clear…*all* successful businesses have some sort of management accounts. Not necessarily the 10 pages, signed off by the accountant, but something meaningful to their business which provides the key information we've talked about in this book.

And – cover your ears accountants – it is better to get it 90% accurate quickly than 100% accurate by which time the cash has run out. It'll give you a picture, a broadly accurate picture, of where you are.

One thing it should include, which we haven't mentioned yet, is the financial position of the business. This shown in its balance sheet, sometimes called the statement of financial position, (or as Sarah calls it the 'Where am I at' statement) and is the relationship of its assets, liabilities and equity at a specific date.

- An asset is something owned by the business such equipment or stock, and also includes debtors, which are owed to the business.
- A liability is an obligation owed by the business such as amounts owed to suppliers and banks, the settlement of which will give rise to an outflow of resources, usually cash.
- Equity is the residual interest in the assets after deducting its liabilities.

Hence the name *balance sheet*; the amount a business owns (its assets) must equal the amount it owes (its liabilities plus equity). And the reason equity is an amount it owes is because it owes this amount to its owners (or shareholders in the case of a limited company).

The reason the statement is drawn up to a specific date is because it is changing all the time; in an ongoing trading business assets and liabilities are being generated and settled respectively and equity (the amount the entity owes to its owners) is, hopefully, increasing as the business makes a profit.

Whether you prepare your management accounts yourself, or have a bookkeeper or accountant prepare them for you, *do not accept less than a profit, cash flow and financial position statement every month*. This is because unless the balance sheet balances, the profit and loss and cash flow statement could be providing you with misleading figures.

These three statements are the minimum you should review at least monthly, but for a fuller understanding of your business numbers we recommend that a business dashboard is prepared every month as well. The precise information it should contain will depend on your business but as a start we suggest the following:

i. A reconciliation between profit and cash flow;
ii. An analysis of sales and margins by customer and product;
iii. Marketing numbers such as cost of customer acquisition, average sales value; customer lifetime value, etc.;
iv. Debtor days outstanding;
v. Stock turnover;
vi. Cash flow forecast.

Do I need an accountant?

A question we are frequently asked is ‘do I need an accountant to prepare my accounts for me?’ The advice we always give is that bookkeeping and accounting is easy *if the system is set up properly.* However your time is valuable and it may *not* be best spent doing your own bookkeeping. So our advice is to outsource your bookkeeping to a specialist bookkeeper (your virtual assistant will know someone) and use your *really good accountant* for their specialist help which should be to:

i. Design your accounting system and help you choose an accounting package;
ii. Create your business dashboard;
iii. Meet with you to review your monthly numbers;
iv. Show you ways to grow your sales, reduce costs and increase profits;
v. Prepare your year-end accounts and file your tax returns.

What do I look for in an accountant?

Look for an accountant who carries professional indemnity insurance, speaks to you in terms you can understand and charges fixed, rather than time based, fees. Check that the fee includes training you – or your bookkeeper – to use the system and business dashboard. Take a look at their website; is it up-to-date and well written with a blog giving tips and advice.

Make sure your accountant will act as your agent with HMRC to save you having to deal with them yourself, and speak to them directly is any queries arise. They will give you a form to fill in to do this.

Summary – the business numbers you need and where to find them

Business number	Where it'll be
Sales, including sales by customer and by product	Income statement
Break-even point	Dashboard
Gross margin by customer and by product	Income statement
Overheads	Income statement
Net profit	Income statement
Tax payable (income or corporation tax)	Income statement
Debtors and debtors days	Balance sheet
Stock turnover	Balance sheet
Cash received and paid	Cash flow statement
Cash balance	Cash flow statement
Cash expected in and paid out	Cash flow statement
Tax and VAT due	Cash flow statement
Loan repayments due	Cash flow statement
Cost of acquiring a lead	Dashboard
Conversion rate	Dashboard
Average sales value	Dashboard
Customer lifetime value	Dashboard
How much can I pay to get a new customer?	Dashboard

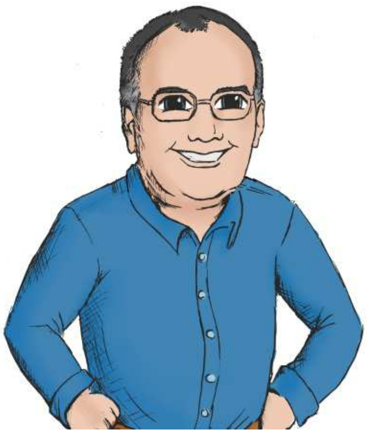
Exercise

Do you have monthly management accounts (even if in a rudimentary form)?

Do your management accounts comprise a profit, cash flow and financial position statement? If not, have you a plan to achieve this and by when?

Do you know how the profit you have made has been spent (ie where the cash went)? Does your accountant *get* marketing and help you understand your business numbers?

About the Author



Noel Guilford is a Chartered Accountant, entrepreneur and author. After leaving University he joined Arthur Andersen & Co., with whom he trained and qualified as a Chartered Accountant, before joining Spicer & Pegler (now part of Deloittes) as Managing Partner of their Chester office.

As a partner in Deloittes he specialised in Corporate Finance acting as lead advisor on numerous acquisitions, disposals and management buyouts.

In 2002 he left and set up Guilford Accounting, a small business accountancy practice specialising in advising owner-managed businesses on current accounting, finance, and tax matters. He is the author of the Figure it Out - an Entrepreneurs Guide to Understanding your Business Numbers (2014) and How to Build a Successful Business and Achieve the Lifestyle You Want (2018).

In 2015 he co-founded My Business HQ Limited which creates business opportunities for people for whom fitting into a conventional 9-5 job may not be an option or because they want to work flexibly. My Business HQ currently offers its My VA Business and My Bookkeeping Business 'businesses in a box'.

Noel lives near Chester, with his wife and dogs. He has two grown-up children.

To find out more about working with Guilford Accounting go to https://guilfordaccounting.co.uk.

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