Financial Management

A simple guide for small business owners

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Introduction

Financial management is not very sexy. It is not what makes business owners spring out of bed in the morning and rush to work.

It is, however, an essential thing for business owners to do well, or at least do well enough.

Surveys of why businesses fail consistently show that poor financial management – lack of cash, insufficient funding, a surprise tax bill, no performance measurement – is often a major reason for business failure. So business owners ignore this activity at their peril. Whether they do it themselves, hire someone to do it or outsource it, it needs to get done.

The purpose of this eBook is to break down what good financial management looks like so that you can put this into practice in your own business.

Good financial management consists of:
* Goal setting
* Setting shorter term targets
* Funding
* Forecasting
* Measurement
* Review and action

Let's look at each of these in turn.

Goal setting

As the saying goes, 'If you don't know where you are going, any road will take you there'.

Setting a long term financial goal for your business is a good starting point. It is something to work towards and gives a business a purpose and a direction.

A good way to do this is to think about your 'exit' from the business sometime in the future. What would you need to be able to step back from the business and retire or do something else?

So, let's say £500,000 would give you a reasonable retirement. Your business either needs to build reserves of £500,000 (after tax of course) or perhaps you could sell your business for this sum when it gets to a certain size, or it could be a combination of building reserves and a business sale.

You now have your long term financial goal. The next step is to break this down into shorter term targets.

Short term targets

Your short term targets should be aligned with your longer term financial goal.

For example, if you want to exit from the business in five years' time when the business has a value of £500,000, your annual targets for the next five years need to take you, step by step, towards this goal.

The target should be broken down into sales and costs for the year and then by month. Ideally, as well as sales and costs there should be cash flow targets.

In the course of putting together these targets, or your plan, it is possible that you might identify a funding gap for the business. In other words, in order to achieve the targets the business may need some external finance to maintain healthy cash balances and make the necessary investment to achieve the desired levels of growth

Funding

Some businesses can achieve their growth targets with minimal funding. Typically, these will be businesses with low set up costs and where their customers pay them sooner than they pay their suppliers.

Many businesses are not in this fortunate position and to trade successfully they need some kind of external financing.

Recognising this need and putting the right kind of finance in place can make the difference between a hard slog and a relatively smooth ride.

There are various types of funding. Some are complex and involve third parties taking an ownership stake in your business. These are not touched on here where we focus on typical sources of finance used by business owners of smaller enterprises.

Loan

This is one of the most common types of funding. It could be a personal or family loan or it could be from a bank or ‘peer to peer’ lender.

The advantages of loans are that repayments are generally fixed monthly amounts and the interest cost and charges are known and can be built into financial plans.

As the business grows, the loan is repaid and the business may start to build its own cash reserves so refinancing may not be necessary at the end of the loan term.

A loan can be a good vehicle where there are up front capital costs for the business.

Overdraft

The advantage of an overdraft is that you only pay for what is used. They can be useful for funding ‘working capital’, for example if your customers take a while to pay you, the overdraft can fill the gap.

Factoring and invoice discounting

Like the overdraft, factoring and invoice discounting are useful for funding customer invoices.

A factoring company will pay you a proportion of the invoiced amount when it is invoiced and the balance when payment is collected.

Disadvantages are the cost of the service and a loss of direct control of how the factoring company interacts with your customers.

Invoice discounting works in a similar way to factoring but you retain responsibility for collecting payment from your customers, which may, or may not, be a good thing.

An important part of funding is the relationship a business has with the lender, more often than not, their bank. Having a good banking relationship is vitally important for many businesses and your accountant can help with this by ensuring that financial information is presented professionally and in a timely manner.

Forecasting

At Base52, we believe that forecasting is one of the most important, but often overlooked, aspects of financial management.

For a business owner to have an accurate and flexible forecasting mechanism that can be quickly updated for changes is an extremely powerful tool.

Typically, a forecast would cover a rolling 12 month period and if updated regularly it keeps the business owner in control and avoids the risk of surprises, like getting half way through the year and realising you are 50% behind your profit target. The forecast should give an early warning of any issues ahead so that remedial action can be taken.

If a business has reasonable cash reserves, a sales, profit and reserves forecast may be sufficient. If cash reserves are tight, it is sensible to supplement the profit forecast with a cashflow projection, usually covering a 12-13 week period and showing how actual cash balances move during this period.

Measurement

Now, this is what gets some accountants excited! Counting the beans or measuring what is actually happening with the business finances.

The first step is having a regular monthly routine when the books are updated and management reports are prepared showing a profit and loss, balance sheet and debtors and creditors (or, put another way, what the business was owed at the end of the month and what it owed).

Ideally, your management reports will also show how you are doing against your short term targets and the forecast can be updated for the actual costs for the year to date

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Simple stuff. Basically it’s about having a bookkeeping and reporting routine and sticking to it. Having produced your numbers, though, there is another essential step to take, to keep your business on track and that’s covered in our final section below.

Review and action

So you've done your bookkeeping, you have your fancy reports. Pat yourself on the back, shove them in a drawer and get on with the next job.

Before you do that. there is something to do before you move on. That is, understanding what the numbers are telling you and taking action accordingly.

There will be basic tasks to carry out – the VAT bill to pay, supplier payments to schedule, customers to chase. On top of this there may be other matters to look into – are you spending more than you intended on business travel? Have your insurance costs increased? Why has your profit margin decreased? Why have a particular product's sales fallen?

Spending time each month looking at your management accounts, interpreting the results and taking action will pay dividends in the longer run.

Where next?

This eBook set outs the elements that we believe, together, make for sound financial management.

If you do all of these things well you should have a good ‘hand on the tiller’ and be able to steer your business in the direction you want it to go. If some or all of these elements are missing it might be a choppier ride and you will be travelling on your business journey without essential information to help you make the right decisions

This is a complex and wide ranging subject and the aim of this eBook is help you put some of the foundations in place. If we can help in any way please contact us.

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