Outback Accounting

From Cambodia to the Pilbara

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June 2017

Give a man a fish and you'll feed him for a day.
Teach a man to fish and you feed him for a lifetime.

Chinese Proverb

The Credit Union Foundation of Australia (CUFA) has taken this proverb to heart – and not just for men … !

For years now, CUFA has been supporting Financial Literacy programs and Village Entrepreneurs across South East Asia and the Pacific Islands.

The latest addition to this program deals with particular business skills, specifically book-keeping and accounting, that enhance the viability of businesses across the Cambodian countryside.

To be useful, programs like this must be hands-on, face-to-face and on the ground. CUFA has achieved all this. CUFA has given great support to the volunteers who have joined in this work.

One of those missions has resulted in an accounting and book-keeping training program for Cambodian villagers.

Success in Cambodia suggested that the content of that program might find a wider application, so the underlying script is contained in this book.

The Workbook can be downloaded at www.iniPax.com/Summaries/Outback_Workbook.

The script is based on a Case Study that is very topical for Cambodia: a Chicken Farm.

The simplicity of the arithmetic makes the more exotic features of financial accounting easy to follow. And those accounts lead on to diagnostic methods that can keep these businesses healthy.

The program needs nothing more than pencil and paper, a downloadable Workbook – and an enthusiastic interpreter / presenter.

It's been a success in countryside Cambodia. There's every reason to believe that it will find application in any community with a taste for self-help – and a desire for a business that will feed them forever ….

Contents

Book-keeping

The program starts with a simple book-keeping exercise to introduce the importance of keeping records.

It introduces the Case Study, a Chicken Farm. Something that sounds reasonably appropriate and topical.

The figures have purposely been kept really simple – perhaps rather unrealistic. That avoids complicated arithmetic and lots of figures - and that's OK because the book-keeping principles are what's important.

Before you begin, the first thing to do is download and print the Outback Accounting Workbook. You'll be filling in the numbers as you go – and doing some simple arithmetic. There'll be references to Workbook page headings throughout the book.

The program is designed to show how successful businesses keep track of their money, how they do what's called ***book-keeping***.

And then it goes on to do what doctors call a ***Diagnostic***: using our book-keeping to check out the health of a business. We're going to become Business Doctors!

The good thing is that the Book-keeping and the Diagnostics are designed to fit together really well – so you can follow every step along the way.

Are we ready … ?

What we're going to do is start off by being book-keepers for an imaginary chicken farm. You'll get some figures to start you off with and then we'll work through some more detail. Before you know it you'll be accountants and business managers.

So our business is an imaginary chicken farm – and maybe the figures will sometimes look a bit silly, but it's done it this way to show how everything fits together, how it all works, without getting too complicated.

Go to Workbook page: **Book-keeping**

So let's start.

First off, it's your lucky day. You begin with $500.

The Workbook already shows that $500 at the top of the table ...

Now I don't know the real price of chickens here in Cambodia, and I told you I was going to be silly, so your chickens are going to cost $3 each. Maybe they're going to lay eggs made of pure gold!

So what does 50 chickens at $3 each come to?

You're right. $150. Write that down beside ***Buy Chickens*** under your $500.
So what should we look at next…?

I said I was going to make it easy. At least at the beginning, so let me say ***Chickenfeed***. We'll buy a year's worth, so that's going to cost $100.

Write that down alongside ***Buy Chickenfeed***, under the $150 for the chickens.

How much is left of our $500?
? $250

Half our money is gone already!

Is there anything else?

Yes. For a whole year, we'll have to pay ***Rent***.

$50. Write it down next to ***Pay Rent***.

What's left now?
? $200

Anything else?

A ***Fence***. We've paid big money for our chickens, so we don't want them to run away.

Another $50 where it says ***Buy Fencing***.

What are we down to now?

? $150

Surely we're finished!

Anything else?

I can think of something: you Cambodian people are much too unselfish…

What are you going to live on? You need to pay yourself something.

So there's another $100 we can write in as ***My Pay***.

Same as you paid for chickenfeed. I told you I was going to be a bit silly, but it would be useful to see the story unfold with these simple numbers. It's the story that's important, not the numbers.

So how do we look now? What's left of our money?

Do we agree that we're now down to $50?

It's a bit sad to see all our money disappear so quickly. But has it?

Costs and Expenses

Now we take our first step towards the kind of accounting that will help diagnose a business.

I use the word Diagnose because that's a word that doctors use when they're checking our health, so it's also useful to use for a business. And people will probably understand what Diagnose means.

This first step sets up the idea of what accountants call a Profit & Loss Statement – but I think it's easier to understand if I simply call it a Profits list. It introduces the idea of Variable and Fixed costs and why the difference is useful for our Diagnostic.

Let's look at a couple of things:

What's the difference between chickenfeed and rent?

What would happen to your chickenfeed costs if you had half the number of chickens?

Of course. Your chickenfeed cost would go down by half.

But what about the rent if you lost half the chickens?

Nothing would happen at all. Your rent doesn't depend on the number of chickens.

So you could call the rent a ***Fixed*** cost and the chickenfeed a ***Variable*** cost.

Let's look at another thing:

What's the difference between chickenfeed and fencing?

You're right. At the end of the year the chickenfeed is all gone but you've still got your fencing. The money you paid for the chickenfeed is all gone, but the fences are still worth what you paid.

Same with the chickens themselves (depending on how healthy they are!)

So the chickenfeed and the rent – and your pay - are what we can call ***Expenses*** because when they're gone, they're gone.

On the other hand, you still have the chickens and the fencing at the end of the year. It's almost as though you still have the money – it just looks a bit different!

So let's now make another list.

Go to Workbook page: **Profit List (1)**

This time we'll start with the costs that vary directly with the number of chickens. What we've decided to call the Variable costs.

Under where it says ***Variable*** costs, you'll see chickenfeed. Alongside that, write $100.

Great.

Next you'll see ***Fixed*** Costs.

Under that, let's put $50 for Rent

… and under that, My Pay $100.

What does all that add up to?

? $250

That's terrific. Now we're starting to get a picture of the cost of running a chicken business.

Sales

As well as Costs, the Profit list also needs to show the money that's coming in. Sales.

This part shows how to work out a figure for Sales by looking at various product lines – in this case, Eggs and Chickens.

The idea is to look at what's reasonable for production and what's reasonable for prices.

So is there anything missing?

Go to Workbook page: **Profit list (2)**

Back up here at the top… Sales. We don't have a business if we don't have Sales.

If we have a chicken farm, what can we sell?

- Did anybody say eggs?
- Did anybody say chickens?

Let's think of some numbers.

How many eggs might we get from our chickens? One every day from every chicken? That's 365 a year. I don't think we want to work our poor chickens quite that hard.

So pick a nice easy number. Why don't we say 100 a year for each chicken?

50 chickens, 100 eggs each. What does that come to?

? 5,000 eggs.

Now what if we say we can sell 10 eggs for $1 … ?

At one dollar for every 10 eggs what does that come to?

? $500.

Wow. We're making money!

But remember also that we paid $3 for each of our chickens. That should make any chicken worth $3, so what if we decide to hatch some of those eggs instead and then sell the chickens…

So instead of selling 5,000 eggs for $500, we might hold back and hatch 100 eggs. That means we could sell 4,900 eggs for $490 and 100 chickens at $3 each.

Or even better, we might sell 50 chickens for $3, which comes to $150, but keep the other 50 to add to our flock (also worth $150). We won't get any money from them straight away, but they'll soon be laying eggs of their own and we'll have more to sell next year.

So back up to here at the top.

In the blank lines under Sales we can now write:

- Eggs $490
- Chickens $150.

And our Total Sales.

? $640.

Getting exciting!

Profit (1)

With Sales and Cost figures in place, we can now look at what we're earning: Profit – and Profit comes under different names.

We can talk about Gross Profit and Operating Profit. Later on we'll add Net Profit.

Separating out these various kinds of Profit means that we have something we can use in our business Diagnostic tools.

This is where you start becoming real business managers.

This is where the arithmetic begins.

Go to Workbook page: **Profit list (3)**

The first thing to do is to subtract the Variable cost from our Sales, the cost of actually keeping the chickens alive, the $100 for the chickenfeed.

So what's left after we've taken away the costs of feeding the chickens?

? $540

That's a very rough and incomplete version of the Profit we're making. For accountants it has a name that you might as well know: to them, '*rough and incomplete*' means Gross. So it's known as ***Gross Profit***.

If you want to know how well the actual chicken part of the business is going, you look at Gross Profit. If you want to increase your Gross Profit, you need to find a way of increasing your Sales or reducing your Variable Costs.

The next thing is the Fixed costs. Somehow we have to include them to get a more realistic picture of the business. So the next step is to subtract the cost of Rent and our Pay.

$50 (Rent) plus $100 (My Pay) comes to $150.

If we subtract that $150 from Gross Profit, we're left with what's called ***Operating Profit***.

We now have a much clearer view of what the business is actually earning.

By my arithmetic, the Operating profit is $540 minus $150 - which comes to $390.
Fantastic.

But there's a little more to go before we get to our final Profit. There's something else to talk about first.

Assets

All of this leads logically to the accountants' next list: the Assets List.

A business is worth more than just the difference between Sales and Costs. It also has things of value that aren't sold but help the business make its money.

In our Case Study, we have two examples of Assets: the chickens and some fences. Along with the Cash that was left over right at the beginning.

Remember that as well as various expenses, our book-keeping list also had things like fencing and chickens. But you'll notice that neither of these appears in what we've just done. That's because they are not Expenses but what we call ***Assets***.

Assets are things that we own – and we'll still own in a few years because they don't get used up. We keep Assets on a different list because it works better that way if we want to look at what the business is worth.

The list we've been building so far shows the Profit we're making after all the bills have been paid – which is why it's called the Profit list. (It's really called the Profit and Loss statement by the realists, but let's us be positive and just call it the Profit statement!)

The Assets list is a bit more than that: it's also a list of the things we owe.

The things we own are called ***Assets***; the things we owe are called ***Liabilities***. Right now it will show our chickens and our fencing, but if we decide to borrow money to expand the business, that loan will show up as a Liability, the opposite of an Asset.

So let's make our Assets list.

Go to Workbook page: **Asset list (1)**

This list has a line down the middle. Over on the left side we'll make a list of ***Assets***. Over on the right side we can list our ***Liabilities***.

At this stage, we've only got Assets, but let's make a list anyway.

What have we got?

- Fencing… worth $50.
- Chickens… Worth $150.

So now it looks as though we have assets of…

? $200 …

But I still feel as though something is missing…

I know… what happened to the $50 of cash that was left over right at the beginning? We've still got that, and Cash looks like an Asset to me, so there's no harm in adding that to our list.

So let's add another line called Cash.

? $50

So what does our Asset list look like now?

- Fencing worth $50.
- Chickens worth $150.
- Cash worth $50.

And what does that add up to? What are our Total Assets?

$250.

It's a bit less than the $500 we started off with, but we now have a working business that can earn money, over and over again.

Profit (2)

Things are now starting to get interesting – and a bit more realistic.

We all know that things wear out. That's a fact that shouldn't be forgotten. This next part shows how 'Wearing Out' can be added to our Profit list - and our Assets list.

It also show that our lists have to fit together – which is what makes them even more useful as a Diagnostic tool.

But there's still something not quite right.

Let's go back to our Profit list.

This shows the money we get from selling things and the money we've spent on getting the things to sell … our various Expenses.

But is that all there is?

This is a hard one, but I'll give you a clue. You'll find it on our list of Assets, the things we've paid good money for. Money that we've already seen is a bit different from the chickenfeed.

The chickenfeed and the rent – and your pay - is all gone at the end of the year. But nothing lasts for ever. Even fencing doesn't last forever and will have to be replaced. And so will the chickens. Two of the things on our Assets list.

We have to put that cost somewhere, because it is a kind of Expense.

We could put the full cost on our Profit list at the time we paid the money – but that would make our Profit figure unrealistic, really terrible – both for the year we paid the money and the following years when it looks as though we got it for nothing.

Go to Workbook page: **Profit list (4)**

What if we think about how long our fences will last – and how long our chickens will live…?

Probably silly again, but what if we say they both last for five years and then have to be replaced. How do you think we could use this idea?

What if we take one fifth of the cost every year for the five years and call it another kind of Expense? We could call it a '***Wearing Out Expense'***.

Our Profit list now has another line. It does look a bit unreal because it's not money we've actually paid, but it is realistic if we are looking at whether our business is making a profit or not.

So what did our fences and our chickens add up to?

? $50 + $150 = $200.

And what do we get if we divide $200 by 5?

? $40

So let's write '***Wearing Out Expense***' under our Operating Profit line. Subtract that and we find ourselves with a new measure of Profit that's getting closer to the real thing: the Profit that's left after we've taken away everything we can think of.

Our accountant friends call it ***Net Profit***.

So what does Net Profit come to in your calculation?

? $390 - $40 = $350.

We've made a Net Profit, after we've thought of everything, of $350.

So now we have a Profit list and an Assets list.

And our Assets add up to $250.

Is that true… Or am I still missing something?

Go to Workbook page: **Asset list (2)**

The Wearing Out Expense makes our Profit list look better, but now the Assets list doesn't feel right.

Everything has to fit together, so we can't put a Wearing Out factor on the Profit list and not have something also show up on the Assets list.

We've decided that every year for the next five years the Profit list will show one fifth of the original cost – and that's fair enough, but our Assets list is different because it has to show that the Asset becomes less valuable every year as it wears out over its five year life span.

The way it's done on our Assets list is that each year's Wearing Out factor gets added to last year's Wearing Out total. At the end of five years, the original value and the Wearing Out factor are the same number, so that in the end, the total value of these Assets becomes exactly zero because we said they would wear out.

Maybe they have, maybe they haven't, but at least we've been honest about our Profits and our Assets values.

So what does our Total Assets now add up to? $210.

Cash

One final list, the third of three.

For the survival of a business, this one is probably the most important. This is the list of actual Cash transactions. The Profit list shows deals but not actual Cash. Buyers don't always pay immediately. That's reality, but we do need to record actual cash so we know we can pay our bills.

It's useful too, to separate the cash list into different parts: the actual Operational cash, the Investment cash that's spend on new assets and the Financing cash that comes from lenders or business partners.

How are we going?

I think you're doing brilliantly, because your lists look terrific.

So I think it's worth adding one more thing. We'll take a glimpse into the future.

Our Assets list shows chickens, fencing and cash. At the moment, our cash figure is $50, but it's worth taking a closer look at what our actual Cash really adds up to.

So now we can start another list.

Go to Workbook page: **Cash list (1)**

Like the Profit list and the Assets list, our ***Cash*** list also has some special headings. They show the different places our money comes from and where we spend it.

There are three things we need to look at:

1. Our **Operating** Cash. The money we get from customers and the money we pay to suppliers and employees: the actual money we use to operate the business.
2. Our **Investments**. The money we pay for the things that wind up on the Assets list and the money we get if we sell it off later on.
3. Our **Financing**. The money we get if we go to the bank and borrow – or if we let a partner buy a share of the company.

That makes the Cash list very easy to read – and most of all, the bottom line will show us how much money is actually in the bank.

That bottom line is worth watching because the worst thing of all is not to have money to pay your bills. Because that makes people very angry!!

So you watch your Cash list very carefully and make sure it's always up-to-date.

OK.

So let's build that Cash list.

First, we'll deal with Operations, so back to our Profit list:

1. Money from customers:
   - ? Sales: $640

2. Money paid to suppliers and staff:
   a. chicken feed ($100);
   b. rent ($50);
   c. pay $100)
   - ? Running Costs: $250.

That's the money for actually keeping and selling our chickens.

But what about our Wearing Out allowance? Where do we put that?

The question is whether any actual cash actually changed hands?

You're right. There was no cash.

The Cash list should only show ***Actual*** cash. So it can be left out.

What do we have now when we take Cash to Suppliers and Employees ($250) away from Cash from Customers ($640)? Not complicated: $390.
The next thing is the money we pay for things that we've added to the Assets list.

Any ideas?
Fencing? $50.

That's great. Write that down.

There is another interesting thing. Can anybody guess? The chickens we bought at the beginning for $150.

If we think of them as egg laying machines, you can see that they're worth adding as the same kind of Asset as the fencing.

There's one more thing.

Remember how we sold all those eggs, but kept back 100 to hatch as new chickens. Remember too that we then sold 50 of those chickens, but kept back 50.

They've got to be worth something. Even though it might look as though we got them for nothing because we hatched them ourselves, we must have paid for breeding them and keeping them.

So we should add something here for that cost. If we had a full book-keeping system, we'd probably know how much, but for now we'll just have to guess.

Let's allow $50 for breeding those chickens.

We'll add that to our list of egg-laying machines …

Of course this means that they're worth $50, so we should add that to our Assets list. Like we've already seen, all our lists fit together. Everything has to balance.

So this ***Investments*** section consists of $50 (fencing) plus $150 (original chickens) plus $50 (newly hatched chickens) – which all adds up to $250 cash out.

So what's our total now?

Operations: $640 (Sales) less $250 (Payments) comes to $390.
And our Investments, the Assets we've paid cash for, come to $250.

So there's $390 cash coming in from operations and $250 of cash going out for our fences and our egg-laying machines.

The next line is for any extra money we might have borrowed from the bank or received for a share of the business.

I don't recall that we've done any of that, so there's nothing to write here.

So if we put all this together we find that $390 minus $250 equals $140 of actual cash.

Now we come to a really interesting part. Down at the bottom of our Cash list.

There are three more lines: the first is for the increase (or decrease) in the cash. That's $140 increase.

For the next line, you'll need to think back.

Remember how we started off at the beginning with $500.

The second line is that $500 of Cash at the beginning.

The third line is Cash at the End – which is $140 + $500: $640.

So you see why this third list, the Cash list, is really important. We now know we actually have $640 in cold hard cash at the end of the year.

Ownership

The final thing in our simple Case Study is to show what the business is worth to the person who's put all the time and effort into starting it up and keeping it running. The Owner.

A few extra lines are added to the Assets list to show the value of Ownership … also known as Owner's Equity.

We've now covered an awful lot of things and we now have three really useful lists.

Go to Workbook page: **Asset list (3)**

But just a moment. I've just remembered our Assets list. What did it say about Cash? How much Cash did it show? Can anybody tell me? I recall that it said $50.

But our new Cash list has just shown that at the end of the year we actually have $640, so we'd better fix our Assets list with this new figure.

And the other thing for our Assets list is our new egg-laying machines. The new ones we talked about on our Cash list. We can add their value to the Assets list as well. That's another $50.

So now our lists look terrific. We've also shown, yet again, that if we change one list, there's usually something to change in another of our lists. And that's what we've done. So now we're finished.

Does this look like every dollar has now been accounted for?

I'm sorry to say that that was a trick question. There's one more thing that still doesn't show completely – and for you, it's really important.

Remember the cash we started off, right at the very beginning, before we bought anything? The $500.

That's $500 that you must have saved up to start your business. $500 you could have used on lots of other things but you chose to put into the business. Your money. It shouldn't just disappear and your contribution be forgotten.

It has been shown on our Cash list, but there is another place in our lists where everybody can see that you've put that money in and that you are entitled to the benefits the company can bring.

Let's go back to our Assets list and what it might show at the end of the first year.

What do all the Assets add up to?

Our Net Assets are $850.

Now let's look at our numbers in another way.

What do we get if we take the original $500 and then add the Net Profit figure from our Profit list?

? $850

Wow. Just like magic! Exactly the same as our Net Assets!

So the proper way of doing all of this is to add three more lines to the bottom of the Assets list and call them ***Ownership***: (or what some call ***Equity***).

Your very first contribution:	$500.
Plus Net Profit:	$350
Comes to Total ***Ownership*** (Equity)	$850

This way everyone can see what you've put in – and have the right to take out honestly.

That's only fair.

Business Diagnostic (1)

We can now use our lists to begin some simple but useful Diagnostic tests.

The tests aren't complicated. They're simply an introduction to why our lists are so useful and what can be done with them.

At this point, we'll do a couple of Profitability calculations to show how these diagnostics work.

We're now at a very interesting point.

What you've written down is better than just a list of numbers.

You could look at these numbers and see:

- How your business is performing
- How it compares with other businesses
- As time goes by, you can see whether you're getting better or whether there are things that you need to improve.

So how do we do that…?

Workbook page: **Diagnose your Business (1)**

Let's start with a look at our ***Gross Profit***.

How much Gross Profit did we make? $540.

How much is that as a percentage of our Sales? 84%.

Which is really interesting, because if we look at lots of other businesses, we often find that Gross Profit is around 80%.

Not every business is the same, of course. And it's not an exact figure, but it's enough to start you thinking.

If we're not getting 80%, are we doing something wrong – or are we really just different?

If we're getting 90%, have we forgotten something we should have paid for?

If we're getting 50% are we spending too much?

So much for Gross Profit. What about Net Profit?

The same idea applies.

How much Net Profit does our Profit list show? $350.

And what's that as a percentage of sales? $55%.

The rest of the world thinks that less than 10% is hardly worth the effort; more than 30% is usually too good to be true.

Again, there might be perfectly good reasons. But at least we know that we need to look at our figures more carefully.

Have we forgotten something? Are we paying too much for something in our Operating costs?

Where can we make improvements?

If I was a banker considering a loan, I'd look at these figures and wonder how truthful the borrower is – or whether they really know enough about the business they're trying to run.

On the other hand it might be a really good investment because the borrower has had an idea that nobody else has had before and therefore deserves to be supported.

This business of comparing yourself with other businesses is called **Benchmarking**. So far we've only looked at a couple of things but you can see how useful it can be for somebody trying to make their businesses run better – or wondering whether it's wise to lend them money.

Already, just by looking at our Profit list, we can get something useful. But we can also use our Assets list.

For instance, we have a figure for the Profit we're making, and we also have a figure for the value of all our Assets – and another for what we've invested in the business … the 'Ownership' figure.

What do we get if we divide our Net Profit by Total Assets and turn it into a percentage? 41%.

And what if we divide Net Profit by the Ownership figure? 41%.

These figures aren't always the same. They are right now because our Assets list isn't very complicated. As a guide, though, a figure of around 20% is a bit like the rest of the world.

At this stage, the figures aren't very realistic- which is what I said right at the beginning. But they do show how you can get an idea of what you're getting for all the money you've invested.

Having said all this, I should add that you shouldn't get too exact about these things. Every company, every industry, every sized business is different.

The important thing is that it's good to watch these Benchmarks year after year and compare them every year as you go along. That way you're comparing with exactly the same business every year and can see how you're really going.

If you're a banker. It's often better to build up your own list from the businesses you know.

Now you've done all your book-keeping in the professional way and heard about ways of analysing your business, you can imagine how useful it will be to deal with real figures.

In the next session, we'll work a lot more on business diagnostics, but already you can see the kinds of questions you can ask. Things like:

- Have I forgotten something really important?
- Do the figures look so wrong that you wouldn't lend money to this business?
- Do the figures look so exciting that you'd love to lend money to this business?

These last two questions are really important, especially for a Banker, because you can now start thinking about which business you'd lend money to.

- Most profitable
- Best benchmarks
- Most realistic
- Most trustworthy.

Pause …

Here's where you might like to take a break and prepare for the second half.

There's much more to all this, of course, but we've made a great start.

You've seen how to keep records of your business, and, especially, how to set out those records as lists that will help you make the business – and your life – much better.

It's a way of working that lets you get more out of your business – and reduces the risk of going broke.

And for a banker, it's a way protecting other people's money, the money you're asked to lend to enthusiastic business owners …

A New Year

The second session has a little more on the three lists, mainly on the effect of taking out a load and on accounting for unpaid bills.

At the end of this piece, the book-keeping has reached quite a sophisticated level without being too challenging.

Now here's an interesting thing: while you were having your break, we've moved into Year 2 and our landlord has offered to sell us the land we've been renting. Great news. No more rent to pay.

The only problem is that the price is $1,000 – which we don't have. Even though there's some cash in the bank, there isn't enough. But it's worth finding that cash somewhere.

There are a few choices that we'll come to later when I talk about Financing, but for the moment, let's keep it simple: let's go to the bank and borrow the money.

The bank almost certainly won't let us borrow the whole $1,000. They'll want us to put in at least some of the money ourselves. We can expect to need something like $200 of our own savings. Which we can do because we had cash left over at the end of our first year.

So let's say that the bank is comfortable with what they see and agree to lend us the $800 we need. We can now buy the land, but we'll also have to pay the money back - and we'll also have to pay interest. I won't go into the calculation now but let's say the bank wants $150 each year for 10 years.

This means that our lists will have to change yet again – the Profit list, the Assets list and the Cash list.

The Profit list will now show that we're paying interest – but we can now drop the cost of rent. Not a great improvement to the bottom line right now, but it will get better as the years go by. Paying off the loan means that we'll be paying less interest each year because we only pay interest on what's left of the loan… the reducing balance.

Go to Workbook page: **Profit List (5)**

So let's start off by changing our Profit list. We'll drop the Rent figure and add the Interest and Repayments to the bank ($150).

Go to Workbook page: **Asset List (4)**

The Assets list will change too, because we now own the land. We can add the full price of the land, the $1,000, to the Asset side of the Assets list.

But we also have to show the $800 that we borrowed from the Bank and now owe. So now we have something on the Liability side of our Assets list.

We're going to have to wait a moment before we add a figure for Cash, because that's going to come from our Cash list in a moment.

And while we're still on our Assets list, there's another thing we should take care of. People don't pay their bills straight away.

When we bought our fencing for instance, did we pay straight away or agree to come back with the money? When we sold our chickens, did we get our money straight away or did we allow our buyer to come back later with the money?

Sometimes we do, sometimes we don't. But if we don't pay or get paid on the spot, we don't actually have the money – or we haven't actually paid the money.

So to be entirely truthful, we can't call it Cash until we actually receive it or actually pay it.

Yes, it's nearly as good as cash, but not quite, so our Assets list shows the money that we're going to receive as an Asset called ***Receivables*** – and the money we're going to pay as a Liability called ***Payables***.

These Receivables and Payables are both important and they both need to be watched carefully. Receivables especially. It's sad but true, but people hate paying their bills. It's human nature, I'm afraid.

But those unpaid bills are still your money – even though it's in somebody else's bank account, not yours. Somebody else is using it to earn interest or make their business better. Money that could be used to improve your own business.

Collecting money is no fun, and I find it the least enjoyable part of business, but we have to spend time making sure we get paid. And paid quickly. I've seen businesses go broke because they couldn't pay their own bills … all because somebody else hadn't paid them on time, What's actually happening is that we're lending our money at zero interest rate – which is something that not even bankers will do … !

So to help us manage our business, our Assets list should show Receivables as an Asset and Payables as a Liability – and we'll have to adjust our Cash list to account for those unpaid bills.

Usually you would get a figure for Receivables and Payables from your book-keeping, but for now, accountants have a way of calculating an approximate figure:

$$Receivables = \frac{Sales \times 45}{360}$$

$$Payables = \frac{(Variable + Fixed\ Costs) \times 60}{360}$$

In our case, the calculation comes to:

- Receivables: $80
- Payables $33

So now we can add Receivables and Payables to our Assets list.

Go to Workbook page: **Cash List (2)**

As usual, we have to make some more adjustments. This time on our Cash list. Cash we haven't received yet (Receivables) and Cash we haven't paid yet (Payables).

So on the Cash list we reduce the ***Operating Cash In*** by the number for Receivables, and the ***Operating Cash Out*** by the number for Payables.

So those figures now become:

- Cash In $560
- Cash Out $167

Recalculate the Cash list and our Cash at the End of the Year now becomes $293.

So now we can go back to the Assets list and update the Cash figure.

Let's redo our Asset calculation. Calculate our Assets minus Liabilities; calculate our Total Equity.

- $750

That final cash figure is a little disappointing, because we now have less money at the end of the year than we had at the beginning.

It might be disappointing, but the truth is that just about every business is like this at the beginning. Business people often talk about a '***Payback'*** period when all those startup expenses are being paid back – and that can often be two or three years.

Things will look better as the years go by though, because we'll be paying off the loan to the bank – and because the cost of the land will only show in this one year. And as the years go by, the value of the business will rise as the debt is paid off our stock of breeding chickens builds up.

The great thing is that we've seen the way we can look into our business through these lists and understand what's going on. We've also seen how all these lists fit together and how everything balances out.

In a little while, I'll talk some more about how we can use these lists to check out the business, how healthy it is and what could be improved.

Before I do that though, I'll go back and talk a little about getting money to make the business bigger.

First I'll talk about borrowing money from the bank - and then I'll also talk about another way: taking on a business partner who will pay for the honour of taking a share of our business!

Financing

This Financing part isn't complicated. The 'Borrowing' part focuses on how a borrower needs to treat the bank – and gives a few ideas on what a banker should ask about the risks posed by a borrower.

Not too technical, it's more about proper behaviour and expectations.

Borrowing

Financing is the word we use for getting money from somebody else to do something we need to do now but don't have enough money of our own.

One way is to go to the bank and take out a loan, borrowing some money that we agree to pay back – and to pay interest for until it's all paid back.

The way it usually happens is that when we take out a loan, the deal will probably be to pay a certain fixed amount of money every so often. It will normally be more than just the interest cost, so that every time we make one of those payments, we also pay off a little of the money we owe.

The nice thing about that is that every time we reduce the amount we owe, we have less interest to pay – so every time we make a payment, less has to go into interest and more goes into reducing the debt … which reduces the interest and reduces what we owe … which reduces the interest and reduces what we owe. Until it's all paid off … Hooray!!

That's fine, but there something we must always remember about getting a loan in the first place.

We can't just walk into the bank and expect to be given money. The bank gets its money from people who put it with the bank for safekeeping – and to earn some interest of their own. And just like the rest of us, the bank has to have actual cash for everyday use. It must have money to lend. And if it's lent money, it wants to be sure that it will get it back as agreed – and that the interest will be paid.

Just like we want to be paid when we sell our chickens and our eggs.

The important thing to remember is that it's not the bank's money, it's your neighbours' money and they expect the bank to keep it safe.

And remember too, that you're not the only person who might be competing to borrow the bank's (neighbour's) money. The bank will only lend money to the person they most trust to pay them back.

So quite rightly, the bank will take great care … and they might even decide not to lend the money in the first place (which is always the best way to not lose it!). Or they might even decide to ask for more interest than usual, just because they're worried that one particular borrower is more risky than others.

Always remember, its other people's money that you're asking for, not just the banker's. Which all means that we have to show the bank that we're worth lending too.

The first thing the bank will need, especially if we haven't borrowed money before, is a plan like I'm describing in this book. You'll also need a way of showing the bank that you're sticking with the plan, that you're getting your bookkeeping right – and if not why not.

And you'll need to be able to show that your plan is realistic. That isn't hard if you know what to look for – and that's what our business diagnostics are designed to help you with.

And there's one more thing. Whether it's your first loan or a new one for a new purpose, the bank needs to believe in you. It needs to believe your promise that you'll pay them back. And they don't have to believe what you say.

If you've borrowed money before, they'll check to see whether you paid it back and whether you made your payments on time. If you didn't do it last time, you can be sure that the bank won't be very helpful this time.

If it is your first time, the bank will probably ask other people how trustworthy you are. Remember, they're just looking for evidence that you can be relied on to use their money wisely.

So rule number one is to make your payments on time. Banks notice this kind of thing, and they have long memories.

And then you need to have a good, realistic plan – and make sure you're known as a trustworthy person.

If you do that well, you'll have a good chance of getting the money you need – and the bank will be doing the right thing with other people's money.

All of which means that you get your money, you pay the interest and you pay back the loan and everything is clear. No more debt.

The great advantage of taking out a loan is that when it's paid back, you have no obligation to anyone and you still own all of the business.

You just have to make the payments – and cover the cost of the interest.

Taking a Business Partner

Taking on a business partner has advantages over taking out a loan. This is an explanation of the relationship between a business owner and a new partner or shareholder.

It also compares borrowing with taking on a shareholder and what both partners should expect.

Borrowing is all very well. Except for one thing: the interest.

Sometimes the money you pay for interest can be very high – even if the interest rate itself is reasonable. The actual money you'd have to pay could take a lot of your income. Even worse, if something terrible happens to the business and it has to close down, you still have to pay off the loan and the interest.

But there is another way.

You could take a business partner who will provide the money the business needs in return for a share of the business's profits. It's not without its problems, but partners like this are often prepared to wait until those profits start coming in - which could well be some years.

And on top of that, if the terrible thing happens and the business does collapse, they know they can't expect to get their money back.

It all sounds good, but as usual, there is a cost. As a business partner they are also a part owner. They own, and will always own, a share of the business. And they'll probably want to tell you how to run your business. To get your money you've given away a share in the company forever.

Of course you first have to find someone who is willing to provide the money, somebody who is prepared to take the risk they could lose it all, somebody who is prepared to wait before they get any return. They're taking a big risk and they'll want to be paid for that risk.

The question will be how big a share of ownership they will want for the money they're putting in and the risk they are taking. They might say they want half of the company because there are two owners … while you might think they deserve much less because of the effort you've put into getting the business up and running.

It's never an easy negotiation, but the better your plan, the stronger your position.

Business Diagnostic (2)

Now we get to do the next lot of Diagnostic calculations.

They take the figures from the three lists and calculate various financial Ratios.

As well as calculating those ratios, we get to interpret those ratios, developing opinions about what they mean and whether anything needs to be done. It shows how these Diagnostic tools are useful both for business managers and bankers.

Go to Workbook page: **Diagnose your Business (2)**

We've already looked at ***benchmarks***, the numbers from successful businesses that can be compared with ours. Over the years our accountant friends have come up with ways of checking and comparing the numbers they've pulled out of those companies.

For our business doctors, using these benchmarks is called Ratio Analysis. Ratio Analysis of financial statements is a big deal because it's so useful – and you can be sure that your banker or business partner will have looked at your ratios long before they agree to lend you any money. That's why benchmarks like this are so useful and why we keep coming back to them.

Liquidity

Mind you it seems like an awful lot of effort. So why should we do all this? What's the point of it all?

You could say that it's much easier to just look at the money you hold. If you have money, you're OK. If you're running out of money, you're not OK.

Profit is a good place to start when you're analysing your business, but there are other things to take care of. One is your ability to pay your bills when they become due.

The accountants call it ***Liquidity***. It's a measure of how much cash you can call on in an emergency.

It's all very well having exactly enough cash to deal with all the things you know about, but business is harder than that. There'll always be something unexpected. You always need to have some extra cash – but not too much. There's a benchmark that helps with this. It's called Working Capital and the calculation is:

$$\textit{Working Capital} = \frac{\textit{Current Assets}}{\textit{Current Liabilities}}$$

The usual benchmark for working capital is around 1.5 to 2. Less than that and you might have difficulty in an emergency; more than that and you've got idle money,

money that you could be using to pay for more machinery or more staff or more marketing … things that could make the business run better.

But here's an interesting thing about the formula: we've already been talking about Assets and Liabilities, but now we're calling them Current Assets and Current Liabilities.

So what does 'Current' mean?

Our accountant friends see a difference between things that last for a long time, surprisingly enough called Non-current Assets (like fences), and things that can vary a lot in the short-term - like Cash. Short term Assets are called Current … money we can get our hands on quickly in case of an emergency. Current Liabilities are the opposite: they are things that have to be paid for in the near future.

Non-currents Assets are valuable for a business, but they don't pay the bills …

Leverage

Borrowing money is like using a lever to extend the use of the cash we have. The accountants call this kind of thing ***Financial Leverage***.

We don't want to borrow money if we earn less than we would pay in interest, but there are times when it can improve the business.

So Leverage is another thing we can use as a benchmark: how well we're using borrowed money.

There are a few ways of looking at Leverage. We can compare our Debt to our Assets, to the Owner's Equity, to the amount of Sales – and we can see how well our earnings cover our interest payments.

So here we have four more formulae:

$$\textit{Debt/Assets ratio} = \frac{\textit{Borrowings}}{\textit{Total Assets}}$$

A good average number is **0.7**.

$$\textit{Debt/Equity ratio} = \frac{\textit{Borrowings}}{\textit{Total Equity}}$$

A good average number is **0.6**.

And two more that relate to Sales:

$$\textit{Debt/Income ratio} = \frac{\textit{Borrowings x 100}}{\textit{Sales}}$$

A good average number is **30%**

$$\textit{Interest Cover ratio} = \frac{\textit{Sales}}{\textit{Interest Payments}}$$

A good average number is **4.5**

So our benchmarks have proven very useful.

The only thing to be said is that benchmarks can vary widely between different businesses, different industries – and businesses of different sizes.

The truth is that although these all-purpose benchmarks are a great starting point, the most reliable benchmarks are those you calculate for your own business after you've been operating for a few years - and you've thought long and hard about how you been running the show.

But there we are. We've only just begun with our book-keeping and we already know the things that will make our businesses run better.

So it hasn't all been a waste of time!

Profitability

Let's see if our Profit list and our Assets list tell us anything more useful. Let's begin with another look at our Profit list.

We've already had a look at Profit Ratios – but our business has become a bit more complicated since we bought the land. So let's look again:

$$\textit{Gross Profit Margin} = \frac{\textit{Gross Profit x 100}}{\textit{Sales}}$$

In our case it comes to **84**%.

$$\textit{Net Profit Margin} = \frac{\textit{Net Profit x 100}}{\textit{Sales}}$$

In our case it comes to **39**%.

We can now check the ratios for industry as a whole and see how we compare.

Let's look at Gross Profit.

Firstly, we find that 80% is a good average for Gross Profit and 10% is a good average for Net Profit. So already we can ask a question about our business. We have a 51% Net Profit rather than 10%, so perhaps we should check whether we've forgotten something in our Operating Costs.

Now let's look at our Sales.

If we could increase our Sales, everything would look much better. Sales all depend on how many eggs our chickens produce. Is there a way of helping them lay more? Is 100 eggs per chicken each year anything like other chicken growers are getting?

What would happen if we hatched more chickens and sold fewer eggs – or the other way round? But if we have more chickens, we would need more chickenfeed so would the end result be any better?

Questions like that come up and we've only looked at the Sales Line.

And then we can move on to the Variable costs, the other part of the Gross Profit calculation.

Are we paying too much – or could we pay more and get more eggs. How do we compare with other chicken growers?

So much for Gross Profit.

Moving on to Operating costs.

Are we paying too much rent? Is there any way we can improve our Operating costs – or has something appeared that we didn't expect. Can the business afford to pay us more!?

Moving on to the Wearing Out allowance, the place where we listed the money we spent on investments like fencing. Would the business benefit from spending more money on improvements to improve production?

With the figures in the Profit list we can think about all these things, try some different figures, see how our Net Profit, our Bottom Line, comes out.

Then you can move on to your Assets list. Already you can see what your business is worth. If anybody comes along and wants to buy you out, you already have an idea of what you should ask.

Or if you have a conversation with your bank manager, you can talk about how well you're doing, how valuable your business is.

And then we can combine our Profit list and our Asset list.

We've already done a quick look at the Profit list, getting a feel for what the Gross Profit and the Net Profit means – and how we can use them to do some fine tuning. But with an Assets list, we can take a wider look at what those profit figures mean.

So far we've compared Profit with Sales. That tells us how well we are controlling the expense of running the

business. But by combining the Profit list with our Asset list, we can see how much Profit we're making on the amount of money we've put into the business. We can now calculate the ***Return on Total Assets*** and the ***Return on Total Equity***.

Those calculations are:

$$\textit{Return on Total Assets} = \frac{\textit{Net Profit x 100}}{\textit{Total Assets}}$$

$$\textit{Return on Total Equity} = \frac{\textit{Net Profit x 100}}{\textit{Total Equity}}$$

Again, we can look at the Benchmarks. A general average for Return on Total Assets is 20% – and in simple cases, it's the same for Return on Total Equity.

We can see there's a difference between our figures and the Benchmarks. What might that mean? What could we do?

Management Ratios

Still with money management: how well do we collect our money and pay our bills?

Payables and Receivables have already been mentioned … money we have to pay, and money owing to us. As a principle, we should collect our money as quickly as we can – and perhaps a little less anxious at paying our bills (but don't tell anybody I said that … you don't want to get a bad reputation for being a slow payer, or people will lose interest in doing business with you).

How do we know whether we are collecting quickly enough or paying in a reasonable time?

Again we have some Benchmarks and some new words: ***Debtor Days*** and ***Creditor Days***.

A ***Debtor*** is someone who owes your money and a ***Creditor*** is someone you owe money to. Debtor Days is the average number of days it's taking to collect your money; Creditor Days is the average number of days you're taking to pay your bills.

You can use figures from the Asset list and the Profit list to calculate both.

The formulae are:

$$\textit{Debtor Days} = \frac{\textit{365 x Receivables}}{\textit{Total Sales}}$$

$$\textit{Creditor Days} = \frac{\textit{365 x Payables}}{\textit{Total Sales}}$$

The general averages for these two benchmarks are **45** for Debtor Days and **60** for Creditor Days.

I personally would like to use lower figures for both of these, although the reality is that it's not easy to do better.

The End

And then, finally, we're through to the end ...

This is all good. We've covered a great deal.

When we started, I don't think too many of you thought you'd be behaving like real accountants, real business managers – or real bankers … but that's what you've done.

We started off with simple book-keeping: lists of what you'd bought and what you'd sold. Keeping records is always a brilliant start.

And then we moved on to something that's a pretty big deal: we took those lists and changed them into the much more useful lists that accountants call Financial Statements. Statements you can look at to see what you're worth – and where you might make improvements that can make life easier and more comfortable (and probably more profitable).

And then you moved on from being Accountants to business doctors, using tried and tested tools to look at how well a business is being run.

And it's not just valuable for a company's health. These are the tools a bank can use when they're being asked for a loan – or when they're comparing different applicants. Money is a valuable thing and there's never enough to go around, so it has to be used wisely - and there'll always be competition between borrowers. And not everybody qualifies to get that money because bankers will always need convincing that borrowers will pay back the money they've been lent.

And then we went back to look at how a business can be financed – because there's always a time when a little more money can pay real dividends. So we looked at whether that money could be raised by taking out a loan or taking on a business partner – and all that that entails.

Best of all, you've done it in exactly the same way that experienced business managers would do the job, using exactly the same financial documents that the professionals use – and you'll be able to keep on using them as your business gets better and better.

About

- As a business specialist, Barry has held senior roles with the Victorian Government's department of business and the Entrepreneurial Services division of Ernst & Young – and his own business, Cooper Advisory Pty Ltd.
- Barry was a founding director of what has now become the National Stock Exchange of Australia – where he currently chairs the Listing & Admissions Committee.
- As well as extensive business advisory experience, Barry has acted as Manager of Education Development in the Faculty of Business and Economics at Monash University, where he has developed and delivered training programs in business development and portfolio management.
- As Cooper Advisory, Barry has built and operates www.inipax.com, a business planning and training website that is open to everybody.
- Barry holds tertiary qualifications in fields as diverse as Finance, Architecture, Engineering, Landscape Architecture, Town and Regional Planning. He also holds a teaching qualification, a Certificate IV in Training and Assessment.
- Barry has delivered Financial Literacy training, in countryside Cambodia, for CUFA (the Credit Union Foundation of Australia).