

Entrepreneur[®]

P85

PHILIPPINES

ACCOUNTING

101

for

SMALL

BUSINESSES

A **step-by-step,**
easy-to-use guide



ad 1 (ifc)

Measuring your progress

Whether you already own a business or are still planning to establish one, this handbook on basic accounting should prove useful to you as an entrepreneur. It will not only help you understand how your enterprise develops from a financial standpoint but also make you better equipped to make informed judgments and decisions in running it.

Running a business can be intimidating particularly for startups, but the entrepreneur can make it less so by learning how to appreciate and use financial data in planning and controlling the business. The importance of accounting to any business, no matter how big or small, can thus be never underestimated. Without accounting, in fact, there is absolutely no way to find out—much less to precisely measure—whether or not your business is making any progress in achieving its strategic goals and profit objectives.

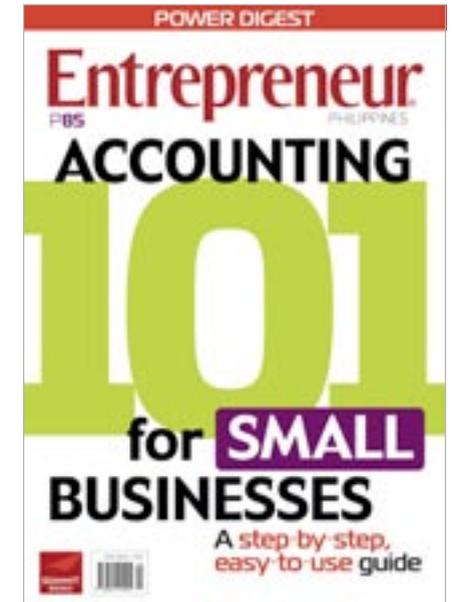
The text for this handbook was written by ENTREPRENEUR contributor Henry Ong, who writes for the regular “Financial Adviser” section of our magazine. He is the president and chief operating officer of Business Sense Inc., a financial advisory and consulting firm that helps owners of small and medium sized companies create solid, reliable, and timely financial reporting systems for their businesses. His firm is the Philippine member-company of INPACT International, a global group of accounting firms with representation from over 60 countries around the world.

To provide some light touches to what is oftentimes perceived as a rather intimidating if not really difficult subject, we asked our regular contributing illustrator, Frantz Arno Salvador, to do some illustrations for the handbook. The illustrations may not exactly make accounting easier, but they surely could make reading the handbook much less daunting—perhaps even inviting—to its readers.

Whatever the case, there is no doubt in our mind that reading this accounting handbook can put you in a much better position to prepare your own roadmap for success for your entrepreneurial venture.

Ping

JOSE M. GALANG JR.
jose.galang@summitmedia.com.ph



Entrepreneur

PHILIPPINES

Entrepreneur Philippines

is published by Summit Publishing Co. Inc.
All rights reserved. © 2008 by Summit
Publishing. Address all correspondence
to Entrepreneur Philippines, 6th Floor
Robinsons Cybergate Center Tower 3,
Robinsons Pioneer Complex, Pioneer St.
Mandaluyong City 1550

JOSE M. GALANG Jr.
EDITOR-IN-CHIEF

LEAH B. DEL CASTILLO
MANAGING EDITOR

JIMBO OWEN B. GULLE
ASSOCIATE EDITOR

LITO C. UYAN
ART DIRECTOR

MISHELL M. MALABAGUIO
ASSISTANT SECTION EDITOR

RAFAEL SANTOS
SENIOR STAFF WRITER

FRANTZ ARNO SALVADOR
ILLUSTRATOR

HENRY ONG
CONTRIBUTING WRITER

Summit Publishing Co. Inc.

PRESIDENT AND GROUP GENERAL MANAGER:

LISA GOKONGWEI-CHENG

PUBLISHER:

AURORA MANGUBAT-SUAREZ

VP FOR OPERATIONS:

ANSEL DELA CRUZ

EDITORIAL DIRECTORS:

MYRZA SISON, JO-ANN MAGLIPON

GROUP PUBLISHER:

GED VENTURA

ASSOCIATE PUBLISHER:

DENISE MARIE C. CONGCO

PUBLISHING ASSISTANT:

ISABELLA VICTORIA SARMIENTO

ADMINISTRATIVE MANAGER:

WHILMA LOPEZ

ADMINISTRATIVE ASSISTANT:

ROSALIE ARTETA

Interactive

PUBLISHER:

DENIS DEL CALLAR

WEB BUSINESS OPERATIONS MANAGER:

DENNISON KO

WEB MASTER:

JOSE PAOLO GILGEO

Production

PRODUCTION DIRECTOR:

INTET J. VICTORIANO JR.

ASSISTANT PRODUCTION MANAGER:

JANE M. PUNO

PRODUCTION COORDINATOR:

DINA A. JESUITAS

ADVERTISING TRAFFIC ASSISTANT:

ARTHUR VILLAFLO

In-Magazine Promotions & Design and Events Groups

MARKETING DIRECTOR:

MARCIE S. LINAO

CREATIVE DIRECTOR:

NOEL G. AZCUETA

In-Magazine Promotions & Design - Marketing 2

PROJECT OFFICER:

KAYE B. ESTOISTA

MARKETING ASSOCIATE:

BILLIE L. LIBORO

MARKETING ASSISTANT:

SAN S. FRANCISCO

CREATIVE ARTISTS:

MARTIN P. FLODELIZA,

KENNETH B. JAVIER, DONNA Q. TAPAY

Events - Marketing 3

PROJECT OFFICERS:

LEAH H. BASCO, MA. CHRISTINA TAN

JUNIOR MARKETING ASSOCIATES:

MIRELLE QUIZON, KRIZTEL LORBES,

ALLAN ANTHONY ALTERA, DONNA

FUENTES, GINA PAULA GUEVARRA,

MAAN PE, ANTONIO MARTIN,

EDUARDO JAY ALMEDA JR.,

MONICA LOUISE VALDIVIA, MARJORIE GO,

AIS SIMBULAN, ARLO VICENCIO

Trade Marketing

TRADE MARKETING MANAGER:

ANNE CHRISTINE O. ONG

TRADE MARKETING OFFICER:

ERNEST D. JAVIER

SENIOR TRADE MARKETING ASSOCIATE:

TRICIE P. CUASAY

CONSUMER PROMOTIONS ASSOCIATES:

CANDACE U. LOBENDINO, CHARLES L. CHUA

TRADE PROMOTIONS ASSISTANT:

SHEENA A. MONGALO

VISUAL MERCHANDISER:

WARREN E. ESPEJO

MERCHANDISING ASSISTANT:

TIMMY C. SEBASTIAN III

MERCHANDISING COORDINATOR:

RACHELLE A. LOSENADA

Special Publications Department

EDITOR-IN-CHIEF:

DONDI LINGENCO

CREATIVE DIRECTOR:

NOEL AZCUETA

ASST. MANAGING EDITORS:

SUNSHINE SELGA, IZA SANTOS,

MAYREEN YAPCHIONGCO, CAMILLE BESINGA,

TIMOTHY PANGANIBAN, PATRICIA PAREDES

EDITORIAL ASSISTANT:

MICHELLE ACANTILADO

ART DIRECTORS: **AMERICUS AFABLE,**

JONAS ASISTIO, DINO DE OCAMPO,

CINDY DY, CLEONE FLORES-BARADAS,

MEMS GAMAD, BONG SEVILLA JR.

SENIOR GRAPHIC DESIGNERS:

JANE KRISTINE CRUZ,

ALONA FRANCISCO-MARTINEZ,

ERIC MENDOZA

Media Relations

MEDIA RELATIONS MANAGER:

RO MANALO

MEDIA RELATIONS OFFICER:

INGRID VILLAFUERTE

MEDIA RELATIONS ASSOCIATES:

JUNI CALINGO,

GEORGIA DELOS REYES

MEDIA RELATIONS ASSISTANT:

HAZE ROMAWAC

Advertising

GROUP ADVERTISING DIRECTOR:

FLORENCE BIENVENIDO

ADVERTISING DIRECTOR -

KEY ACCOUNTS GROUP:

REGIE UY

KEY ACCOUNTS SPECIALISTS:

JOEY ANCIANO, CHA CLARINO,

JUNN DE LAS ALAS, ALEX REVELAR,

ANNIE SANTOS, SUZETTE TOLENTINO

KEY ACCOUNTS ASSISTANTS:

CHINGGAY CABIT, MARICEL SAMSON,

DIANNE SUEGAY, ONNIE DEL MUNDO

Circulation

CIRCULATION MANAGER:

ALMA M. MADELO

CIRCULATION MANAGER GMA:

GLENDA GIL

PROVINCIAL SALES MANAGER:

ALEXIS MARTINEZ

INTERNATIONAL DISTRIBUTION SPECIALIST:

ULYSSIS JAVIER

DISTRIBUTORS GROUP HEAD:

CAROLINE HERRERA

KEY ACCOUNTS GROUP HEAD:

ALAINÉ MAE LOZADA, MALOU RUBINOS

SALES REPRESENTATIVES-GMA:

VIVIAN MANAHAN, CHARLOTTE BARLIS,

BEA VELASQUEZ, NOREEN SESCON-PELIGRO,

JENNY REPAREP, VER TORRES,

LHON BITUIN, JINKY ROSE CALUGTONG,

JENNIFER TOLENTINO, EDWIN AQUINO,

JOHN LAKHI CELSO

AREA SALES SUPERVISOR-LUZON:

RUDDOLFO MANLANSING

AREA SALES SUPERVISOR-VISMIN:

RODEL REVILLA

SALES REPRESENTATIVES-PROVINCIAL:

VICMAR DAVE AWID, SERMAND LACZA,

JAMES RUSSELDRIIS, JEROME ESPEJO,

FERDINAND ORETO

NEWSSTANDS SUPERVISOR:

JOEL VALDEZ

SR. CIRCULATION SUPERVISOR:

MAYLEEN LARON

CIRCULATION ADMIN ASSISTANTS:

ARLENE SANTILLAN, FLORA MARIE MANDIA,

ROXANNE HALLI

DISTRIBUTION ACCOUNT ANALYST:

ROGELIO CABALLERO, JR.

SUBSCRIPTION SUPERVISOR:

HECTOR CASTILLO

SUBSCRIPTION COORDINATOR:

JOFET ABAD

SUBSCRIPTION & DIRECT SALES OFFICERS:

EDUARDO ZURBANO

LOGISTICS MANAGER:

NORMAN OCAMPO

Entrepreneur Media Inc.

2445 McCabe Way, Irvine, CA, USA 92614

CHAIRMAN/CEO:

PETER J. SHEA

PRESIDENT:

NEIL PERLMAN

SENIOR VP/CFO:

JOSEPH GOODMAN

Contacts

For local dealership/distributorship inquiry

call Circulation at 451-8888

Look for: **CAROLINE HERERRA**

and **MAYLEEN LARON** • For international

distribution inquiry call Circulation at 451-8888

Look for **ULYSSIS JAVIER** • For back issues

call Filbar's at 4139688/7262787

Look for: **LOEL/VIVIAN**

ad 2

8 **INTRODUCTION**
Why even small
businesses
need accounting

20 **CHAPTER 4**
Setting up an
accounting
system



24 **CHAPTER 5**
The various
financial reports

41 **CHAPTER 10**
Managing inventory

44 **CHAPTER 11**
Managing payables

10 **CHAPTER 1**
Why accounting
is crucial
to your business

13 **CHAPTER 2**
The first five
basic accounting
concepts

17 **CHAPTER 3**
The other
six basic
accounting
concepts

28 **CHAPTER 6**
Financial analysis

32 **CHAPTER 7**
Budgeting

35 **CHAPTER 8**
Cash flow
management

38 **CHAPTER 9**
Managing
receivables



Summit Books
is the book
publishing
division under
Summit Media.

Summit Books is committed
to providing the public with
reasonably priced, quality,
contemporary books.

Its vision is to get
Filipinos in the habit of
buying and reading books
and to do for books what
Summit Media has done for
magazines.

ad 3

Why even small businesses need accounting



After many years of working for a multinational company, Jane, a successful marketing executive, quit her job and partnered with her best friend in college, Amie, a culinary graduate who used to work for a five-star hotel in Makati City. They then opened a pizza restaurant in the university area along Katipunan Avenue in Quezon City. Confident of her previous training in a reputable marketing firm, Jane did the marketing research for the business herself, including choosing the location and determining its market potential. On the other hand, Amie took charge of the operations side, handling menu design and staff recruitment.

The pizza restaurant proved to be an early success. Just a few months after opening day, it had already developed many loyal custom-

ers particularly from the university area. As its sales grew, Jane and Amie continued to make improvements in the business. They intensified their promotional efforts and raised their food standards. Indeed, they were so happy with the results of the business venture that they already started planning to expand it.

While doing their expansion planning, however, the partners discovered something odd: Despite the fact that their sales had been growing steadily, they were not generating enough cash to finance a new outlet. They didn't have

any idea either of how much income they were making monthly, even after already paying the salaries of the restaurant staff and all their other operating expenses. The only thing they knew was the amount of cash sales they were generating daily, which they would then use to pay for supplies and purchases. And the strangest thing of all was that sometimes, after disbursing their payroll, they would have very little cash left in the bank.

The partners then began to wonder how come they were always short of cash when

their business was supposed to be a cash cow. They started to suspect that they might have been pricing their products wrongly because most of the time, they had been using only cost estimates instead of actual historical costs. They also began to fear that something might be wrong with their inventory system, and that perhaps some of their warehouse staff might not have been doing a truthful inventory of their supplies. They also began entertaining the idea that because they had not established a firm marketing budget, they might have been overspending on their marketing expenditures.

Many owners of small businesses are, in fact, like Jane and Amie. Despite having built good businesses, they sooner or later find themselves struggling with their finances. They are unable to keep track of where all their funds have been going; worse, they are unable to figure out if the business is making any money at all or actually losing—and by how much. The reason is that they don't have a sound accounting system.

For entrepreneurs to succeed in a business, however, they need to focus not only on operating it but on making money from it, and a good way to know if the business is indeed making money is to keep reliable records of its income and expenses that can be reviewed regularly.

This record-keeping process is what we call accounting. ■

Why accounting is **crucial** to your business



ad 4

Accounting is important to you and your business for many reasons. To begin with, when you have an accounting system, you will know how your business has performed financially during a particular period, and you can also evaluate how you had managed your cash flows and other assets. You can do this by reading the different financial reports that you can gener-

ate from your accounting records, such as your balance sheet, income statement, and cash flow. A qualified accountant in your company can help you interpret the financial figures in the report correctly for evaluation and decision-making purposes.

Also, if you are planning to expand and would like to raise money by taking in new investors, you need to consult your accounting records regarding the net worth of your

business. Net worth is the residual capital left when you deduct all of your liabilities from your assets. Now, when you have a clear idea of how much your net worth is, you can use that as a starting point for valuing your business. The valuation that you arrive at will then become the basis of the selling price that you will offer to your prospective investors.

Assume, for example, that you found your net worth in the balance sheet to be P500,000. Depending on how much equity in the business you are willing to sell, you can raise additional funding based on your net worth. In this particular case, if you raise P500,000 in additional capitalization from

Using the income statement to **discover** problems

In the case study presented in the introductory chapter, Jane and Amie could have discovered their problems earlier if they had an income statement that they could review regularly. An income statement is simply a financial statement of a business showing the details of revenues, costs, expenses, losses, and profits for a given period.

For example, upon finding a significant variance between their budgeted gross profits and the actual result, the partners could have investigated it further to see if there was something wrong with their pricing or inventory system. And they could have fixed this inaccuracy by implementing proper costing procedures and internal controls.

new investors, your ownership will be diluted to 50 percent. This is because the net worth of the business would expand to P1 million against your original equity contribution of P500,000. Without proper accounting of its assets and liabilities, however, you would not know the true net worth of your business.

If you are unwilling to give up part ownership of your business, on the other hand, you would need to borrow money from the bank instead. Even in this case, however, you still would need to prepare your financial statements because your bankers will want to examine them to determine your financial standing. Normally, banks will only lend you the amount they think you can afford to pay. They will also check how much assets you have in your business and how much cash flows your business is generating.

There may be instances, in fact, when banks or investors would ask for your business plan. To make a business plan, of course, you need to project your financial performance into the future. And to do the projections properly, you need to have reliable historical financial data that you can only get from your financial statements. By reviewing past financial performance, you can discover so much information about the behavior of your sales, costs, and expenses. Indeed, understanding the factors behind the numbers will help you make your forecast better.

You can therefore see that without accounting, it is almost impossible for you to know how your business is doing. It is accounting that will help you understand the financial dynamics of your business. Indeed, when you know how your business behaves, you would be in a much better position to manage it properly and control your risks. Having an accounting system will help you see to that. ■



The first five basic accounting concepts

As you prepare to set up an accounting system for your company, it will be good to first know the 11 basic accounting concepts behind the preparation of financial statements. These basic accounting concepts are as follows: business entity, going concern, the historical cost principle, the revenue principle, the matching principle,

the accrual basis of accounting, the materiality principle, the disclosure principle, the objectivity principle, the consistency principle, and the conservatism principle.

We will discuss the first five basic accounting concepts in this chapter.

1 Business Entity This is the most basic assumption in accounting. Thus, when

you are in business, you don't ask your company to pay for your personal credit cards or for your expenses at home. This is because you are your own entity—an entity that is separate from your business.

This principle is critical in accounting because it is necessary to account properly for all expenses related only to your business operations. It would be misleading if your personal expenses at home—expenses that have nothing to do with your business—are included in the income statement. Doing so will increase the expenses of your business, creating the impression that your business didn't do well even if it did.

Following the concept of business entity, the ownership of assets must also be kept separate. If the car or the laptop computer that you are personally using was paid for by your company, it belongs to the company, not to you. If you have made a cash advance from your company, you have the obligation to pay it back to your company in due time. And if you use the services of your company for your personal use, you need to pay for it just like an ordinary customer.

2 Going Concern Because the company is separate from you, it is assumed that your business will continue to operate indefinitely even if you are no longer its owner. Your business can be transferred to anyone in the future if you decide to sell your ownership, and it shall continue to exist regardless of your personal situation. This is the concept of going concern.

This concept also provides that in accounting, no matter how much in losses a business may have accumulated over the years, it is always expected to continue running. As the owner of a business, even if you have a bad year this year, you need to always look for-

ward to recover the following year and make a profit eventually. Even if you are losing now, your goal in the business is to eventually make money over time.

3 Historical Cost Principle The principle of historical cost simply states that all assets and services you acquired should be recorded at their actual cost at the time when the transaction occurred. Assume, for example, that you want to buy secondhand office furniture for your new business and you happen to have a friend in the furniture business who could give you a big discount. You checked



that the furniture you plan to buy was selling at P150,000 but you were offered by your friend a discounted price of only P100,000. Using the historical cost principle, you should record this acquisition at the actual cost of P100,000, not at the cost of P150,000 which you believe is its real market value at the time you acquired it.

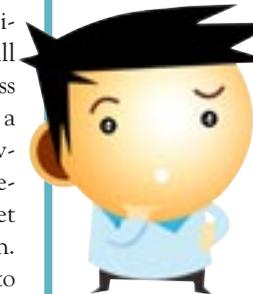
Once recorded in the books, the historical cost of the assets you have acquired shall remain in the records as long as the business exists. For example, suppose you bought a property in Makati City for P5 million. Several months later, because of the high demand for properties in the area, the market price of your property increases to P8 million. Should you adjust the value of your price to reflect the current price at P8 million? Based on the cost principle, the value of the property should remain at its historical price regardless of its fair market value at any time in the future.

The reason behind the use of the historical cost principle is to remove any potential bias that you may have when valuing assets. The argument for this practice is that when you use your actual cost, the report will be more objective and fair. This is still the widely prevailing practice in many accounting systems, although the current trend in accounting standards is moving towards updating certain types of assets to current market price.

4 Revenue Principle The revenue principle requires you to record sales when it is fulfilled and earned, not when cash is collected. For example, if you sold merchandise to your client on credit and the latter promises to pay you next month, how are you going to record this transaction? Under the revenue principle, you should record sales during the month you sold the merchandise regardless of whether you have received cash or not.

MR. ENTREP SAYS:

The historical cost principle also applies to borrowed money



The historical cost principle also applies to liabilities when you borrow money in foreign currency. Suppose that to finance your importation requirements, you

borrowed US\$20,000 at the prevailing exchange rate of P40 to a \$1. You would then record this liability at P800,000 at the time of the transaction. This is the amount that should appear in your balance sheet when your financial statement is prepared at the end of the month. By the time you are ready to pay your loan, however, it might happen that the peso had by then weakened to P50 to a \$1. Under the historical cost principle, you should record that you are have paid off your loan at its actual value of P800,000, not P1,000,000, but you should also record a loss of P200,000 because of the currency conversion under a lower value for the peso.

This is because you have already completed the sales at that point.

Now, let's change the situation. Suppose your client gave you cash as deposit today to make sure that you deliver the merchandise to him when it arrives next month. Do you record the cash you received as sales? Under the revenue principle, you cannot treat the cash collection as sales because you have not delivered

the merchandise yet; that is, the sale transaction is not yet fulfilled. The cash you received from your client should be treated as a liability instead because you need to return the money in case you fail to deliver the merchandise.

5 Matching Principle Assume that you are planning to buy a franchise to open a restaurant. You paid P1 million for the franchise fee and spent another P10 million for the construction. Now the question is: Do you record these expenditures as expenses during the month even though you don't have any sales yet?

Under the matching principle, you cannot book the franchise fee and cost of construction as expenses because there are no sales to match them with. To match the expenses with sales properly, you need to depreciate the cost of construction over the useful life of the structure. For this example, in particular, you can depreciate the construction of your restaurant for, say, five years so that the monthly depreci-

ation expense can be matched against sales for the month. The same also applies to the franchise fee. In this case, the franchise fee you paid will be amortized over the number of years that the term agreement will be subsisting.

We will take up the other six basic accounting concepts in the next chapter. ■

Applying the **matching principle** to food supplies usage

Suppose you have already started your franchised food business and have made your initial purchase of food supplies from your franchiser. By the end of the month, however, you found out that you still have food supplies left in storage. Should you book the total food purchases during the month against your sales for that month?

Under the matching principle, what should be considered as the cost of sales should only be that portion of your food purchases that has been consumed and actually sold. The unused portion should be treated as inventory to be carried over to the following month for consumption.

If you disregard this principle and book all the food purchases to the cost of sales for that particular month, there would be a mismatch of cost and sales. This mismatch would increase your food cost and lower your income, and you would be misled into believing that the restaurant is not doing well. With proper matching of cost and sales, however, you will be disciplined to regularly count your inventory—which, by the way, will also serve as a deterrent against pilferage.

The other six basic accounting concepts



We will now discuss the other six basic concepts in accounting, namely the accrual basis of accounting, the materiality principle, the disclosure principle, the objectivity principle, the consistency principle, and the conservatism principle.

1 The Accrual Basis of Accounting In business, there are expenses such as salaries of staff, rentals, and other administration-related expenses that have no direct relation to sales but are necessary costs for running the

business. These expenses can therefore be reasonably charged against sales for the current period, but to properly recognize these expenses in your income statement, you need to use the so-called accrual basis of accounting.

When you accrue an expense, you assume that the expense occurred during a particular period even if no cash payment was actually made to cover that particular expense. A good example is that in your business, you are supposed to pay your monthly rental and association dues. In practice, before issuing your check payment for these dues for, say, the month of July, you will wait for the billing to reach you—maybe two

weeks after the end of July. Now the question is: Are you going to record your July rental expense during the month of August? No. Under the accrual method, you should accrue the July rental expense during the month of July even if you have not been billed for it yet.

The accrual basis of accounting, which helps simplify the matching of sales with expenses, is the method preferred by accounting standards for the preparation of financial statements. However, many small business owners find it simpler and easier to use the cash basis of accounting, which recognizes sales and expenses only when a cash transaction is made. In this method, all cash receipts are booked as sales and all cash payments are treated as expenses. Thus, at the end of the day, the small business owner only has to check how much cash is left in the cash register or bank account—if there is some, it is treated as a profit; if there is none, it is treated as a loss.

Other businesses use a modified method of the cash basis of accounting, where they use the accrual method only for certain portions of the recording process. Examples of this practice are the use of depreciation for fixed assets or not treating as outright expense certain inventory or assets acquired through cash purchase.

2 Materiality Principle There are times when you don't need to follow the matching principle strictly, particularly if the amount to be recorded is not significant enough to affect the financial results of the business. For example, if you own a multimillion business and you acquire a printer for your office for P8,500, should you record this as an asset and depreciate it for its useful life of three years? According to the materiality principle, the cost of the printer relative to the size of your business is immaterial, so you can decide to charge the whole cost of the printer as an expense for the year. The reason for this is that no one will consid-

er it misleading for you to expense the whole P8,500 in the first year instead of depreciating it for P1,700 in the next three years against your annual sales of, say, P50 million.

Does the materiality principle apply to purchases of a food cart business?

If you own a food cart business in which you invested P350,000 and you bought a printer for P8,500, would the materiality principle apply to the purchase? Yes. The cost of the printer is very material in relation to the size of your food-cart business, so you need to capitalize it as an asset and depreciate it accordingly. When applying the materiality principle, it's important to use your professional judgment in deciding whether an item is material—meaning significant—or not.

3 Disclosure Principle The preparation of a financial statement does not end with reports stated in numbers alone. It also requires notes and supplementary information that need to be disclosed so users can meaningfully appreciate the financial statement. Indeed, some financial facts not reflected in the numbers may be significant enough to influence the judgment of the user of the financial statement. For example, suppose you are planning to invest in a company. As part of your due diligence, you asked for and were presented its financial statements from last year. Based on the income statement, the company appeared to be profitable to you and you were on the verge of deciding to invest in it. When you looked at the notes to the financial statements, however, you found out that the company is under litigation and that it was

probable that the company may end up paying huge damages should it lose in court. Will you still invest in the company after finding this out? Obviously not.

The disclosure principle normally is used when your financial statements are audited. But when you are preparing your financial statements for your own use, and particularly if they are meant for management use only, you may not need to follow this principle strictly.

4 Objectivity Principle In accounting, all transactions must be supported by verifiable documents such as vouchers, invoices, and official receipts. This is because financial data must be as accurate and as reliable as possible. Aside from establishing the integrity of the information, the documentation also serves as a good internal control mechanism. It helps create an audit trail that you would need when confirming certain transactions in the future. Without this principle, accounting information would be generally subjective, for the recording of the data would then be based largely on opinion.

5 Consistency Principle Because every industry is unique, a business has the discretion to choose which method of accounting practice it deems appropriate. However, the principle of consistency suggests that as much as possible, for your business to have comparable financial results, you need to employ the same accounting procedure year after year.

For example, assume that you have a depreciation policy that requires all acquired transportation vehicles be subject to a useful life of five years, such that the annual depreciation expense for your vehicles would be P100,000. The following year, however, your management decided to change the depreciation period to ten years to cut the annual depreciation expense down to P50,000, thus giving you an extra P50,000 in net income. Is this practice allowable?

Under the consistency principle, this is disallowed unless inevitably necessary. Should a change be implemented, an explanation under the notes to financial statements should be made showing how the change will affect the overall results.

6 Conservatism Principle You need to understand that accountants are trained to be pessimistic when they perform their work. The reason for this is that they want to be fair and reasonable when making decisions that in-

MR. ENTREP SAYS:

Allowances for bad debt



You need to provide for uncollectibles so you are not disappointed if any of your clients fail to pay you.

volve opinions, estimates, and selection of procedures. Being conservative, accountants would always choose the method of accounting that results in a lower profit or a higher liability.

One good example of this accounting practice is making allowances for bad debts. You may be confident that you can collect all your receivables from clients, but your accountant may not be as positive as you are. Following the principle of conservatism, your accountant would normally suggest that you provide a certain percentage of your total receivables as uncollectible so you would not be so disappointed if any of your clients fails to pay you.

Now that you know the 11 basic accounting concepts, you should be ready to set up the accounting system for your business. ■

Setting up an accounting system



When you are just starting your business, a simple record-keeping system may suffice to monitor your collections and expenses. You may even be able to do all the bookkeeping yourself. However, as your business grows and the transactions that you deal with every day multiply, it will become more

and more difficult for you to remember all the details of your finances. You will need to put up a better system for tracking your finances. Perhaps you may have to hire a qualified accountant or even invest in computerized accounting software. Whichever of these you decide to do, however, you will need to set up an accounting system for your business.

Every accounting system deals with books of account and ledgers. So, before planning to set up an accounting system, it is important for you to first get familiar with the accounting cycle and with the books and ledgers needed to track and sustain that cycle. At the start of the month, the two major accounting activities you need to perform are, first, recording transactions in the book of accounts and, second, posting these transactions on the ledger. Recording a transaction is simply to input in the book following a template header as it occurs; posting means recording all similar transactions in a ledger that summarizes and totals them at the end of the month.

By the end of the month, you need to review all of the accounts you have recorded and summarize them in a worksheet that you can use to create a trial balance. At this point, you will sometimes find accounting errors or incomplete capture of transactions, so you need to analyze each account and make the necessary corrections and adjustments. Only after you have done all the adjusting entries should you prepare your financial statements.

This is how accounting is done manually, of course. Nowadays, though, many organizations—even small businesses—use computerized accounting systems. If you can't afford to get an accounting software package off the shelf, you can at least use a simple spreadsheet program to automate the computations and posting of balances to the ledger. Since a spreadsheet program automatically generates a trial balance, you don't even have to prepare one to produce your financial statements.

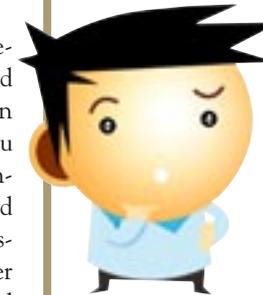
The first thing to do in designing your accounting system is to set up your chart of accounts. A chart of accounts is simply a list of all the accounts in your general ledger, and that list will serve as your guide as to which account to use when recording a specific transaction. It

will save you the trouble of creating a new account for every transaction you make.

The design of a chart of accounts involves assigning of numbers to particular types of accounts for easy reference. For example, asset accounts start with the digit "1," liabilities with "2," owner's equity with "3," sales with "4," and

MR. ENTREP SAYS:

A chart of accounts simplifies accounting for you



Assume that you want to record your payments for brochures, direct mailers, advertising placements, and promotional

items to three different suppliers. If you don't have a chart of accounts, you would be recording each transaction by creating account titles such as "brochure expense," "direct-mail expense," "advertising expense," and "promotion expense." The list can go on and on depending on the number of payments you have made for particular transactions of this type, making your financial statements very long and unwieldy. If you have a chart of accounts, however, you only need to record all transactions for similar activities under just one type of account. In this case, that account would be "marketing expense."

Another advantage of having a chart of accounts is that it also serves as an internal control mechanism. Once a chart of accounts is implemented, no one in your company can introduce a new account or make any changes in it without your approval as the owner.

When you have set up a chart of accounts, you can start planning how to classify similar transactions for efficient recording. Basically, there are five books of account you need to keep: the sales book, cash receipts book, purchases book, cash disbursement book, and the general journal.

Sales book All of your sales should be recorded under the sales book. This will en-

able you to summarize total sales to date and at the same time monitor your customer accounts. When you add up all the entries in the sales book, you will get the total amount of credit sales, which you can then post to the general ledger under accounts receivable.

But how do you identify which customer owes you how much at any time? You can do this by getting the specific entries for a particular customer from the sales book, then posting them to the accounts receivable subsidiary ledger that contains the supporting details for each individual customer.

Cash receipts book This book is used to record all cash receipt transactions. Every time you record cash collections, you also

need to identify whether it is from accounts receivable or from cash sales. At the end of the month, you need to summarize the total amount of accounts receivable collected and post it as a deduction to the general ledger account of accounts receivable. To update the account of individual customers, the specific collection from that customer entered in the cash receipts should also be posted to that customer's subsidiary ledger in the accounts receivable ledger.

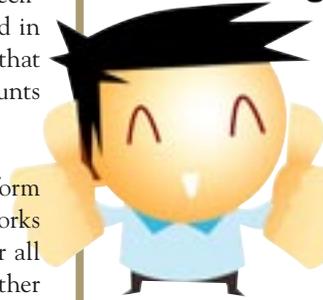
Purchases book Although similar in form to the sales book, the purchases book works the other way around by accounting for all purchases of inventory, supplies, and other assets on account. Everything that you purchase from a supplier needs to be recorded under this book.

Cash disbursement book This book records all cash payments made by the business for its accounts payable and other business expenses. As this relates to accounts payable, preparation of subsidiary ledgers is required for all suppliers with credit terms to help you stay current with payments and balances. The mechanics for posting to the general ledger and subsidiary ledger of the accounts payable are the same as those of sales and cash receipts book.

General journal For transactions that you can't classify under any of the four journals above, you can post them under the general journal book. Indeed, there are accounting entries that can't be considered as sales, as a purchase, or as a cash transaction. Typical examples are depreciation expense and an accrual entry for electricity expense that has not been billed yet. ■

MR. ENTREP SAYS:

Four musts when designing your accounting system



Every accounting system is unique to a business, but no matter how sophisticated or simple you want your system to be, there are four very important things

you need to remember when designing it:

- NO.1** Your system must enable you to exert control over transactions. In particular, the system must help you prevent unauthorized payments or theft from cash collections.
- NO.2** Your system must be compatible with your business operations and organizational structure. What is the use of acquiring expensive accounting software when you can only use 20 percent of its functions?
- NO.3** Your system must be flexible enough to allow you to upgrade it without doing a complete overhaul. Your business may expand in few years' time with new products and services. Your current system should be able to adapt to possible changes in the business.
- NO.4** Always do a cost-benefit analysis when designing an accounting system. Do the benefits of buying an off-the-shelf computerized system outweigh the cost? Are you better off simplifying your accounting with a manual system rather than investing in software packages given your current business setup?



The various financial reports



If you can analyze the debits and credits of your own checking account, then you should be able to read financial statements. Financial statements simply tell you where your money came from, where it went, and where it is now. They come in many forms depending on how you want to customize it. However, when filing your financial statements with such regulatory agencies as the Securities and Exchange Commission or the Bureau of Internal Revenue, you need to formalize the reports according to the standard forms. You may even have to get your financial statements audited by an

independent auditing firm not only to ensure that the figures are correct but also that they are presented according to the International Financial Reporting Standards.

For your own consumption, however, you can simply generate your own report from your company's accounting system. In any case, the report has to be generated on a regular basis so it can help you effectively evaluate the financial performance of your company.

The three types of financial reports that you need to prepare regularly are the income statement, the balance sheet, and the cash flow statement.

Income statement This is your most important source of information about the profitability of your business. In the income statement, you will see how much sales your business has generated and the corresponding costs and expenses it incurred over a specific time period.

The income statement follows a simple format that shows you the amount of sales of your business minus its expenses to yield the net profit or loss.

To better appreciate the details of an income statement in expanded format, consider the financial statement of a trading company that we will call the ABC Corporation.

The balance sheet is your primary source of information about your company's financial position. This is where you get a snapshot of your company's asset holdings and liabilities. The balance sheet follows a simple format that shows how the assets of a business

are financed by liabilities and equity. This relationship is expressed by the famous accounting equation below:

$$\text{Assets} = \text{Liabilities} + \text{Equity}$$

When we say a portion of your business is financed by liabilities, it only means that even if you control it, you don't necessarily own all the assets of the business. The presence of liabilities in the business simply tells you that your supplier or your bank creditor technically owns a piece of your business and that they could actually force you to give them a share of it if you don't pay them.

Your ownership in the business is represented by equity, which is the amount left after you deduct liabilities from total assets. Just like your creditors who expect to be repaid at some future date and earn interest on their loans they have extended to you, you as owner also

ABC Corporation Income Statement For the Year Ended December 31, 2008		
Sales		850,000
Less: Cost of Goods Sold		450,000
Gross Profit		400,000
Less: Operating Expenses		
Salaries Expense	120,000	
SSS, Philhealth and Pag Ibig	9,600	
Rental Expense	35,000	
Marketing Expense	25,000	
Utilities Expense	15,000	
Insurance Expense	5,000	
Depreciation Expense	7,500	217,100
Operating Income		182,900
Other Income and Expenses		
Interest Income	2,500	
Interest Expense	5,000	(2,500)
Income Before Tax		180,400
Less: Income Tax		63,140
Net Income		117,260

**ABC Corporation
Balance Sheet
December 31, 2008**

Assets		Liabilities	
Current Assets:		Current Liabilities	
Cash	350,000	Accounts Payable	350,000
Accounts Receivable	250,000	Salaries Payable	120,000
Inventory	450,000	Others	150,000
Others	125,000	Long Term Liabilities	
		Bank Loan Payable	1,237,740
Fixed Assets:		Total	1,857,740
Leasehold Improvement	650,000		
Office Furniture	250,000		
Equipment	150,000	Equity	
Intangible Assets		Paid Up Capital	1,000,000
Franchise Fee	750,000	Net Income	117,260
		Total	1,117,260
Total Assets	2,975,000	Total Liabilities and Equity	2,975,000

Real-estate income isn't part of a food retailer's regular operations, but...

If you are in the food retail business and the business happens to own a couple of real estate investments for rental, should you consider the rental income part of your operations? You shouldn't; it should be treated as "Other Income" instead. Since your company's core business is retailing, rental income is not part of your regular operations.

However, when you sell real estate owned by your business, your main business may incur an operating loss but still manage to report a net income in the end. This is if the nonrecurring income from the sale of the real estate is higher than your operating losses.

require a certain rate of return on your investment. Indeed, you would be rewarded by an increase in the value of your equity if you decide to sell your ownership shares someday.

Look at the balance sheet of ABC Corporation (table on this page). You can see that all of the assets owned by the company are listed at the left side of the balance sheet, while all of the liabilities and equity are on the right

side. In the balance sheet, the amount of total assets must be equal to the sum of the liabilities and equity.

The explanation for the cash movements in your business—where the cash came from and how it was spent—can actually be found in the cash flow statement. The cash flow statement can actually be created without requiring new data because the needed information

**ABC Corporation
Statement of Cash Flows
Year Ended December 31, 2008**

Cash Flows from Operating Activities	
Receipts	
Collection from customers	250,000
Interest received	2,500
Dividends received	9,000
Total cash receipts	261,500
Payments	
To suppliers	(130,000)
To employees	(120,000)
For interest expense	(5,000)
For income tax	(63,150)
Total cash payments	(318,150)
Net cash outflows from operating activities	(56,650)
Cash Flows from Investing Activities	
Acquisition of fixed assets	(306,000)
Proceeds from sale of fixed assets	150,000
Net cash outflows from investing activities	(156,000)
Cash Flows from Financing Activities	
Proceeds from issuance of capital stock	200,000
Proceeds from bank loans	150,000
Payment of bank loans	(250,000)
Payment of Dividends	(50,000)
Net cash outflows from financing activities	50,000
Net (decrease)/increase in cash	(162,650)
Cash balance, December 2007	512,650
Cash balance, December 2008	350,000

can be derived from your balance sheet and income statement.

However, because the preparation of a cash flow statement involves conversion of certain financial data from the accrual basis of accounting to cash basis, doing the cash flow statement is actually not a very easy task. For example, when you record an increase in accounts receivable from additional sales, that

increase would also require a corresponding deduction from your cash balance. This is because by selling merchandise on credit, your business is in essence lending cash to your customer to buy products from you.

When you read a cash flow statement, you must keep in mind that you need to evaluate your business in terms of three types of activities: operating, investing, and financing. ■



Financial analysis

Entrepreneurs need to develop some sense of control in their financials to keep their businesses durable and healthy. One way of taking control is, of course, by analyzing the financial information generated by the company's accounting system. Through comparative analysis, data that you can find in the financial statements may provide some interesting signals that you can act on.

For example, you may not be aware that

your company may soon be heading for trouble if your profit margins keep on falling for successive months. This may be due to uncontrolled expenses or to the rapid rise of your inventory and accounts receivable levels without your realizing it. Indeed, if no management action is taken, these impending problems could seriously affect your productivity and even threaten your company's survival.

How do you go about controlling your financials through the analysis of the company's busi-

ness results? A common way to do it is by ratio analysis, which is the extraction of a meaningful relationship between any two numbers in the financial statement. Ratio analysis is, in fact, a good way of identifying potential problem areas and opportunities within the company.

To track your financial position without getting overwhelmed with a welter of details, you can analyze your financial ratios according to three measures: liquidity, leverage, and profitability.

LET'S START WITH LIQUIDITY RATIOS

Current ratio You can measure the ability of your business to pay its short-term suppliers through the current ratio, which is computed by dividing current assets by current liabilities. As previously defined in Chapter 6, current assets are those assets that your business expects to convert to cash within the year, such as cash, accounts receivable, and inventory. Current liabilities, on the other hand, are those financial obligations that you expect to pay within the year, such as accounts payable and accruals.

For example, from your balance sheet, you find that you have current assets of P150,000

THE FORMULA:

$$\text{CURRENT RATIO} = \frac{\text{CURRENT ASSETS}}{\text{CURRENTS LIABILITIES}}$$

and current liabilities of P100,000. Your current ratio is therefore 1.5:1, meaning that for every P1.50 worth of cash, receivables, and inventory in your current assets, you have P1.00 worth of payables. This looks all right initially because you have more assets than liabilities. As a rule, however, it is preferable to achieve a current ratio of 2:1 or higher.

Generally, the higher the current ratio you get, the better for you because it means you have a stronger financial position. However, it is no

guarantee that you are managing your resources efficiently. For example, you may have accumulated so much cash in your bank account, thus bringing your current ratio to a high level. This means that you are financially very liquid, but it also shows that you may not be maximizing your opportunities to earn. Instead of just allowing your excess cash to lie fallow in the bank, you could have made it earn more by investing it in another business or in a high-interest-bearing money-market fund.

Acid test ratio As a rule under the acid test ratio, the total of cash and receivables must at least equal the total current liabilities. This is a more conservative measure of liquidity of a business than the current ratio, which tends to be misleading when the current assets account is bloated by excessive inventory.

For example, assume that your business has cash of P50,000; accounts receivable of P100,000, and inventory of P350,000. When you add this up, you get total current assets of P500,000. Then, when you compare their sum with the current liabilities of P250,000, you get a current ratio of 2:1. By just looking at this ratio, it would appear that the business meets the liquidity criteria and can therefore be considered as liquid. But a closer look reveals that its most liquid assets—the cash and accounts receivable—amount to only P150,000 as compared to current liabilities of P250,000.

When we apply the acid test ratio, we add the total cash and receivables—P50,000 plus P100,000—to come up with the sum of P150,000, which is far below the total current liabilities of P250,000. This means that the business is far from being liquid as the current ratio suggests.

Leverage ratios. After evaluating liquidity, we also need to analyze the extent to which the business is relying on other people's money to fi-

nance its investments and operations. The degree of financial risk you are taking when taking debt to help finance the business can be measured by the so-called leverage ratios. The higher the leverage ratio, the higher the risk and the greater the probability of a huge loss if sales projections don't turn out the way the business expects.

An example of the leverage ratio is the debt ratio, which measures the percentage of debt in relation to total assets. For example, if your total debt (including those you had borrowed from the bank to finance your business) is P750,000 and your total assets is P1 million, your debt ratio would be 75 percent.

Alternatively, you can also compute for your debt to equity ratio. First, you derive your equity by subtracting total debt from your total assets to give you P250,000 in total equity. You then divide total debt by total equity, which yields a ratio of 3:1. This means that for every P3.00 you borrowed to finance the business, you have put in P1.00 worth of your personal capital. As a rule, you should not borrow more than half of your total assets, which means not exceeding a debt ratio of 50 percent.

Net profit margin Because profit depends on a lot of factors—among them the nature of the business, the company's market share, and the competitive life cycle of the company's products—there is no fixed rule as to how much profit margin a business should earn. For decision making purposes, however, you generally would want to find out if your profits are increasing and how they compare with those of your competitors in the industry.

The net profit margin is one of the ratios that you can use for this purpose. It is calculated

THE FORMULA:

$$\text{RETURN ON EQUITY} = \frac{\text{NET PROFIT}}{\text{TOTAL ASSETS-LIABILITIES}}$$

by dividing net profit with sales. For example, if your net income is P50,000 and your sales is P150,000, your net profit margin is 33 percent. This figure becomes more meaningful when compared to that of the previous period. If your net profit margin is increasing, it means that you are managing your resources efficiently. If it is declining, however, it means that something is wrong with your operations and you need to investigate and correct the situation.

Return on profit or assets This other profitability ratio measures the rate of return, which indicates the percentage of money gained or lost relative to the investment you put in the business. This rate is commonly known as ROI or return on investment. Strictly speaking, the return on investment refers to the total profit or loss made by the business relative to the assets invested, which can be financed by both borrowings and equity. For example, net profit is P50,000 and the total assets are worth P500,000. To compute for return on investment, simply divide net profit by total assets to get ROI rate of 10 percent. But if

THE FORMULA:

$$\text{RETURN ON INVESTMENT} = \frac{\text{NET PROFIT}}{\text{TOTAL ASSETS}}$$

you compute for return on equity or ROE, you simply remove liabilities from total assets so you use only your invested capital as the main divisor. Assume that total borrowings of the company is P300,000, your equity becomes P200,000, which you will use to divide net profit to compute for your ROE, which comes out at 20 percent. If you have repaid all your borrowings, then your return on investment will be the same as your return on equity. When you know your rate of return, you can use it to evaluate your investment.

One way to appreciate this percentage is to compare it with the prevailing money-market interest rate. If your return on equity exceeds

the bank rate, it means that you have created value for your business. If your return on equity goes below market rate, however, it could mean that even if the business is making money, you might not have been managing your investment efficiently.

EBITDA This term stands for Earnings Before Interest, Tax, Depreciation and Amortization. You use EBITDA analysis when you need to know the earnings capacity of the business. It is often understood as “cash earnings” because it only considers actual cash expenses without non-cash items such as depreciation and amortization expenses. For example, you have an operating income before interest expense and income tax of P50,000 out of total sales of P1 million. Upon closer examination using the income statement, you notice that the reason for such low income was due to huge depreciation expense of P250,000 and amortization expense of P100,000 in the total operating expenses. To compute for EBITDA, you add back the depreciation and amortization expenses amounting to P350,000 to the operating income to get total cash earnings of P400,000. When you know your EBITDA, you will be able to compare the profitability of your company against its nearest competitors on “apples-to-apples” basis. You can also evaluate the capability of your business to repay interest expenses or recover your fixed capital investments by looking at monthly or annual cash earnings.

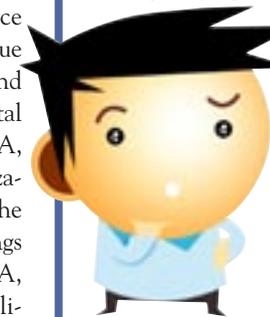
When you want to evaluate business performance, financial ratios as a tool for financial analysis can be very helpful indeed. But these ratios alone are not enough. As important to you as an entrepreneur, you need to interpret them properly and discover which of the ratios is most crucial to your particular business. This way, you can focus on realizing the ideal ratio that will enable you to achieve your financial objectives.

In the restaurant business, in particular, the most critical ratio is the food cost percentage, which is computed by dividing the cost of food by the food sales and multiplying the quotient by 100. This percentage is so sensitive that very strict controls need to be implemented to ensure proper releases of food inventory and supplies.

Yours may be a unique industry, however, so you may need to also develop your own critical ratio to allow you to manage your business more effectively and efficiently. ■

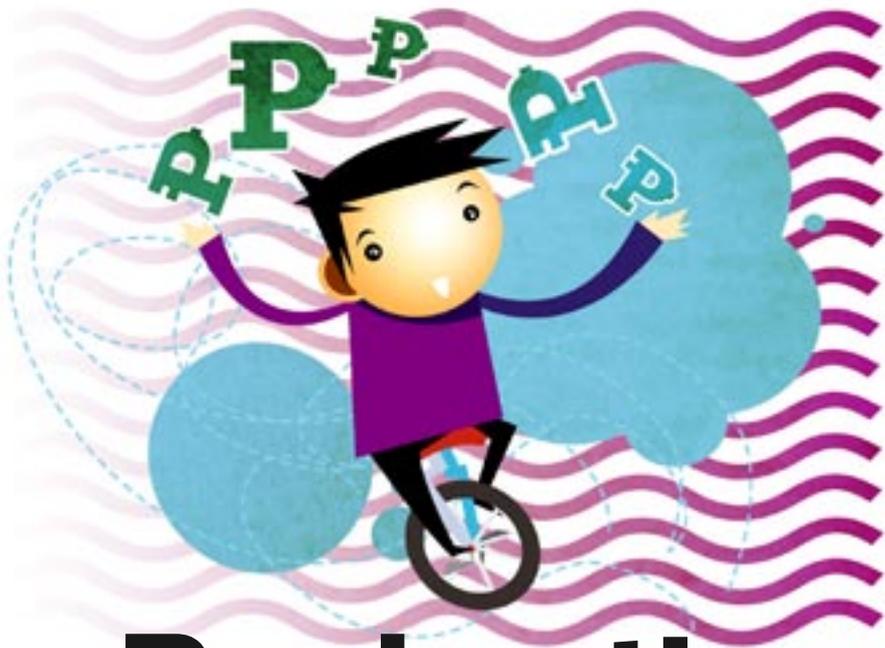
MR. ENTREP SAYS:

The limitations of comparative financial analysis



It's definitely useful to do financial analysis for your business, but it does have limitations. You need to remember that it may not be easy to compare

your financial ratios accurately with other companies because they may be using different accounting methods or different accounting periods. For example, your business may be following the calendar year from January 1 to December 31, but the business you are comparing it with may be following a fiscal year that starts on July 1 and ends on June 30 the following year. Also, your competitor may also be engaged in other product lines that you don't have, which of course would make direct financial comparison between that company and yours extremely difficult.



Budgeting

Budgeting is more than just putting numbers into your spreadsheet after you have made your business plan. It's definitely not an activity to be done only for a few days and then totally ignored afterwards. Because budgeting is based on assumptions regarding how sales and expenses will change in response to changes in your business, it helps you manage your risks and identify opportunities that may come along. Having a budget allows you to specify which resources to use in order to achieve your business goals. Hence, budgeting should be part of a continuing planning process that constantly monitors and measures all of the business functions.

A good budgeting system is one that gets everyone in the organization involved in the budgeting process—from the business owner and key people all the way down to the employees. This is

because budgeting is a very important part of goal-setting for the business. The process can eliminate a lot of confusion and misunderstanding in the organization. It can also effectively impart the entrepreneur's business goals and vision to the employees and provide them with a vehicle for voicing their concerns and sentiments about those goals and vision. Indeed, the participation of the employees in the budgeting process could help ensure the acceptance of those goals and vision and eliminate any pockets of resistance.

Once a budget is approved, it becomes a standard against which performance can be measured. As the budget becomes the basis for controlling all business activities, it establishes the parameters within which you and your employees should function. You should therefore make sure that it is immediately implemented as soon as it is finalized.

For example, you can use the budget to analyze your financial performance by comparing budgeted to actual results. Assume, for instance, that your budgeted salary costs for the previous year totaled P100,000 but your actual spending reached P150,000. You then can look for the reason for the variance of P50,000; you might find out, for example, that it was due to overtime costs that were not fully anticipated. In any case, the outcome of this process can provide you with valuable information for planning the next budget cycle and for keeping your business on track.

Of course, variances will always occur between budgeted amounts and actual results. You therefore need to trace the causes of these variances so you can correct employee behavior that

THE FORMULA:

$$\begin{aligned} \text{BUDGETED SALARY} &= \text{P}100,000 \\ \text{ACTUAL SALARY} &= \text{P}150,000 \\ \text{VARIANCE} &= \text{OVERTIME PAY} \end{aligned}$$

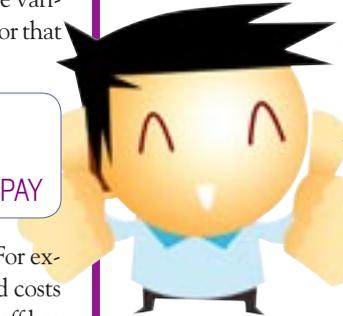
is proving unproductive to the business. For example, you might discover that your food costs have overshot your budget because the staff has not been controlling your inventory properly. There may be times, though, when your staff is not to blame for the variances. These variances may have been caused partially by your company's lack of internal control. Whatever the outcome of the investigation, it is important that the performance evaluation be done in a positive manner. Perhaps you may even consider rewarding your employees every time they meet your budget; this is much better than the counterproductive short-term corrective measure of punishing them each time they fall short of that budget.

One quick way to create a budget is to look at your financials for the previous year and adjust them by a certain percentage to come up with your budget for the succeeding year. For example, if your sales last year was P200,000 and you expect

it to increase by 25 percent, you could set your budget for this year at P250,000. You can then adjust last year's operating expenses upward by, say, 10 percent in computing your net income target. This method is good for a start, of course, but the process should not stop here. Your team should

MR. ENTREP SAYS:

Budgets coupled with incentives motivate people to do their best



Indeed, budgeting can change certain behaviors, but those changes can be either positive or negative. Let's assume that you have an incentive program that offers

your salespeople a bonus each time they achieve their sales targets. If those sales targets are reasonable, your salespeople would obviously be positively motivated; they will work extra hard so they can get their bonus. However, if those sales targets are too high, your salespeople might get discouraged; they might think of those sales targets as impossible to achieve in the first place, so they might just give up without even trying. Thus, setting targets requires you to make sure that you have realistic assumptions, and such assumptions can sometimes prove very difficult to make. Even if you may not get it right the first time, though, you can improve your chances through continuous planning.

MR. ENTREP SAYS:

Always put your budget assumptions in writing!



Making assumptions about the future is a critical part of the budgeting process. Based on experience, the probability is high that you would forget the assumptions you had made several months after finalizing the budget. For this reason, it is wise to always put your assumptions in writing. This way, you can always refer to the document when evaluating variances or when explaining your budget to your investors. This will also help you when you need to modify certain assumptions due to changes in the macroeconomic climate.

thoroughly review the budget to find new ideas and creative ways of controlling your costs, and the inputs resulting from that review can then be incorporated in the final budget.

If you want to have a more detailed plan, you can develop your final budget along with supplemental schedules for operating items. For example, after making your sales forecast, you can create separate budgets for purchases, cost of goods sold, salaries, overhead, and selling expenses in accordance to your sales growth. During this process, it is important that you apply your personal knowledge and judgment in making estimates about the behavioral relationship of your costs with sales. For example, you may

estimate that your salaries expense budget will increase by only 2 percent even if your sales grows by 20 percent because you assume that any increase would only be minimal and would likely only come from overtime costs. As for selling expenses, you may assume that it would increase by 15 percent because you expect to spend more in commission expense and marketing.

You also need to consider the economic factors that may affect your business. Rising competition in your industry may affect your sales and your ability to price higher. Higher inflation resulting from a weakening peso and higher interest rates may increase your operating expenses. Changes in technology and government policy may also affect the way you run your business in the future. So, to come up with a good assumption, you may have to do research on economic trends and assess how these will affect your forecast. You may also want to benchmark against your competitors to get some ideas.

If you are in the manufacturing business, the process is a little more tedious because you need to prepare additional budgets such as a production budget, a direct materials budget, a direct labor budget, and a manufacturing overhead budget. These budgets are critical as these will affect the costing of your product. Normally, you will need the help of your production staff to prepare these budgets because the process of determining the cost behavior of these items may be dependent on the technology of your manufacturing equipment as well as on the set-up of the manufacturing facility.

Now that you know how a good budgeting system works, you have provided yourself with a map that shows you how far your company has grown and how much further you would want it to grow. But always keep in mind that in budgeting, there is no absolute accuracy, only plain educated guesswork. Indeed, you should use budgeting more as a guide rather than as a control tool. ■

Cash flow management

Successful entrepreneurs with a good business concept may consistently register record sales and profits, but they can still go bankrupt because of cash flow problems. Indeed, managing cash flow is a critical area in finance, one that can spell the difference between the success and failure of a business. So, just like smart basketball coaches who develop a winning strategy by reviewing their strengths and weaknesses through the “stats” of their teams, entrepreneurs should similarly monitor their cash flow “stats” to develop an effective financial strategy.

The lifeblood of any business is its cash flow. Without it, the business is like a person drained of blood. If you are always unable to collect your accounts receivable on time, you won't be able

to generate enough funds to pay for your operating expenses. Sooner than you think, you will be in financial distress and may even need to close shop.

This is because the cash that goes in and out of your company is actually what determines your financial position. If you are in cash surplus, you can possibly invest the excess money in short-term investments; if you are in cash deficit, on the other hand, you may need to source financing to bridge your cash shortfalls. Thus, for you to do good forecasts and effectively deal with changes in your cash position, you need to clearly understand the various factors that affect your cash flow.

In businesses where projected sales is the source of the cash receipts budget, managing cash flow always starts with making sales fore-

casts. This is particularly the case if your business doesn't provide long-term credit to customers. Good examples are businesses like food-cart franchises, restaurants, candy shops, service centers, fashion garments, beauty salons, ice cream parlors, and similar activities where sales transactions are made in cash or by credit card. The cash projection can be made simply by assuming the amount of sales you expect to generate for a particular period, then by aligning your expenses accordingly to estimate your cash flow.

But when cash sales are not sufficient to cover your fixed expenses, cash flow problems can occur. Indeed, seasonality plays a key role in cash flow forecasting because it affects the sales pattern for each type of business. For example, in the fashion garment business, monthly sales usually peaks during the holiday season but immediately weakens during the following three months until it picks up again during the summer season. If you are in the accounting business, there won't be so many activities during December, but your business would start to pick up during the first quarter of the following year because of the tax season. Understanding your business is thus very important in making realistic estimates for your cash flow planning.

If you are in the wholesale business, your business would be likely to provide credit to customers. The typical credit you can give to customers ranges from 30 days to over 90 days depending on your willingness to invest in accounts receivable and on the level of competition in your industry.

To accurately forecast your cash flow, of course, you need to know the pattern of cash collections and to also know your customers. There are customers who always pay on time, but there are also customers who always delay and make it difficult for you to collect. A point may even be reached when you need to consider certain accounts as bad because it is no longer possible to collect them. You need to consider all of these factors when planning your cash flows.

When doing a forecast for your cash flow, you may want to use the following template: Start with your actual cash ending balance from the previous month. Add to this balance your cash receipts during the month. After that, deduct your cash disbursement from it during the current month. You will then be able to come up with your cash ending balance for the current month.

MR. ENTREP SAYS:

Get expert advice when making your initial cash flow forecast



It's a good idea to ask your business advisor or accountant for guidance when you are planning to construct your initial cash flow forecast.

Once the template has been made in consultation with him or her, you can thereafter simply put the figures in the template on your own to easily come up with your forecasts. In any case, always remember that having a cash flow forecast can bring a sense of order and well-being not only to your business but also to yourself as an entrepreneur.

This will also be your starting cash balance for the next month, with which you can start doing your projection of cash receipts and disbursement for that month.

For cash receipts, you will need to establish a realistic basis for estimating the next month's sales figure. If you have historical sales data from

the previous year, it would be good to assume a seasonal pattern. For example, assume that your sales in December last year was P500,000 and you noticed that there was a drop of 30 percent the following January. Then, when you make your sales forecast for January in the succeeding year, you need to apply a 30 percent downward adjustment on your preceding December sales. To complete a 12-month forecast, you need to do the same process for the remaining months of the year.

If you sell on credit terms or installment basis, make sure to consider in your cash forecast for a particular month only the portion of the receivable that you expect to collect on that month.

For your cash disbursements, you will need to project your various expense categories, which you can identify from your accounting ledger. For some expense items like rental, electricity, supplies, and salaries, you may simply get their historical monthly averages during the previous year and project those averages to the current year, with some minor adjustments if need be. Another major disbursement item is your payments to suppliers. For this, you will need to project how much inventory has to be purchased monthly to meet your sales forecast. On that basis, you can then project your payments to your suppliers based on your credit terms. For instance, if you need to pay your supplier after 60 days, you have to input the amount you expect to pay for that particular month.

Once you have your forecast showing the total cash receipts and cash disbursements projected for each month of the year, you can get the difference between them to determine your net cash flow. A positive net cash flow indicates that you have generated additional cash to your cash balance; in contrast, a negative net cash flow means you have overspent during the month by that amount, which then has to be deducted from your starting cash balance for the next month. The resulting figure will be your net cash flow for the month in question.

The first month in the forecast always uses the

actual cash balance in the beginning of the month, but it ends with a projected cash ending balance. So, when you forecast for the second month, you simply use the first month's cash ending balance as the cash beginning balance for the next month. You need to follow this procedure for the rest of the months of the year.

As business events unfold during the year, you need to constantly modify your cash flow forecasts. You may have to lower your sales forecast in the middle of the year when, say, you learn that you have lost some significant customer accounts to your competitors. Or you may have to adjust your expenses upward in the last quarter of the year because of the additional sales staff that you expect to hire during the Christmas holidays. These adjustments are necessary to make your cash-flow planning accurate and up-to-date.

When you understand the concept of cash flow and learn how to measure it accurately, you can improve the performance of your business and make it more competitive. ■

MR. ENTREP SAYS:

Sources of cash collections



Your sources of cash collections will either be recurring or nonrecurring:

- Recurring items are those that come from operations, such as sales to customers.

- Nonrecurring items are those that come from investment and financing, such as capital advances from your business partners or proceeds from bank loans and other items of similar nature.



Managing receivables

Do you fear that you will wake up one day to find out that you have to close down your business because you don't have enough cash to pay for all of your financial obligations? And why is it that sometimes, the more you become successful in your business, the higher the probability that you would go bankrupt when you stumble into a serious cash crisis?

This is because many entrepreneurs don't understand that when their sales increases, the level of their inventory and receivables also increases. When this happens, the entrepreneur simply has no choice but to put in more cash into the business to finance its growth.

One way to finance occasional cash shortages brought about by an increase in business activity is, of course, to manage your cash more effectively. You can do this by understanding

the cash-to-cash cycle of your business. The cash-to-cash cycle is simply the number of days it takes you to collect your cash back after investing it in inventory and receivables. The longer you wait to get your money back, which means that you are either unable to sell your inventory or collect your receivables from clients, the higher the risk that you may run out of cash.

You can calculate your cash-to-cash cycle from your financial statements on a regular basis, say monthly or quarterly. This cycle is the average collection period plus average inventory age less the average payable period. When you have this information, you can easily analyze which part of the business you need to improve. For example, assume that based on your last months' results, you have determined your cash-to-cash cycle to be 180 days. You can then investigate which component of the cycle is causing this and seek solutions on how to improve it by reducing the number of days of the cycle.

Your long cash-to-cash cycle problems could be due to any or all of these situations: (a) most of your accounts receivable have long been overdue, (b) you have so many slow-moving items in your inventory that couldn't be unloaded in the market, and (c) you may be paying your suppliers too soon. You can fix these situations by coming up with the necessary policy changes with respect to your accounts receivables. After that, you should monitor the trend of your cash-to-cash cycle during the following period to see if there is any improvement.

You can discover so many things about your business when you make cash-to-cash cycle analysis part of your cash management strategy. Specifically, the analysis will enable you to concentrate on improving your accounts receivable collection as well as your inventory and payable management, thus minimizing your risk of experiencing cash flow problems.

But precisely how do you start determining your cash-to-cash cycle?

Let's first look at each component—starting with accounts receivable—to see how computing your average collection period can help your business.

One good indicator of the credit profile of your customers is your average collection period. To figure this out, you need to first compute your receivables turnover by dividing total

MR. ENTREP SAYS:

Don't let your account receivables bleed out your cash flows!



If you always have a hard time collecting receivables from your customers, it is highly probable that a significant portion of your

outstanding accounts receivable is bleeding out your cash flows. Difficult customers who always pay late are actually borrowing your money interest-free. Indeed, every time your customers fail to pay on the due date, you incur costs that may not be obvious to you. These costs could be in the form of opportunities that you have missed. For example, you could have earned extra income by placing your collection proceeds in the money market. Or the cost may be the actual interest expense you pay for money you borrow from the bank to support your working capital requirements each time you can't collect your receivables.



credit sales with average receivable balance.

Assume, for example, that your total sales for the month was P3.5 million, and that out of that amount, P2.5 million was sales on account. Your accounts receivable at the start of the month was, say, P5.5 million and it ended the month at P3.5 million.

To compute for the receivables turnover, you divide the total credit sales of P2.5 million (sales on account) with the average receivable balance of P4.5 million (P5.5 million plus P3.5 million, divided by 2). This gives you a ratio of 0.56. You then use this ratio to divide the standard 30 days for a month, giving you an average collection period of 54 days.

If your normal credit term for your customers is 30 days and your actual average collection period is 54 days, then your collection is overdue by 24 days. When you multiply this by your average daily sales of P83,333 (P2.5 million divided by 30 days), you will get the figure of P2 million as your total uncollected accounts receivable.

You can now compute the cost to you of the overdue accounts by multiplying that figure by the normal rate of return from your business. If your business is earning, say, 2

percent per month on your investment, then your slow-paying customers are actually costing you as much as P40,000 a month!

You can manage your cash flow better by shortening your average collection period. You can do this either by implementing a stricter credit policy so that your credit sales would decrease in favor of more cash sales, or by intensifying your collection efforts to lower your accounts receivable balance. To have a stronger focus on collection, you can age your receivables by breaking down your accounts receivable balance into “current,” “30 days overdue,” “60 days overdue,” and “90 days overdue or over.” Through this, you can identify the customers with whom your business has the biggest exposure. You can then prioritize your collection efforts accordingly. ■

MR. ENTREP SAYS:

You need to focus on collecting your small accounts receivables!



Normally, you should focus on your small accounts receivables because they have a higher probability of getting

collected. You may treat larger accounts receivables that have long been overdue as uncollectible and therefore need to be written off from the balance. Of course, depending on the outcome of your collection efforts on customers with bad debt accounts, you can always take legal action against them if necessary.

Managing inventory



Do you often experience cash shortages and feel that you are losing when, according to your accountant's report, you are actually making good profits? If you do, you may be overstocking your merchandise inventory for an extraordinary length of time.

Many entrepreneurs tend to overbuy inventory to take advantage of quantity discounts especially if the merchandise comes from abroad,

or when they project their sales targets too high for a forthcoming holiday season. While this could be financially beneficial, the risk of loss could sometimes be greater than the potential rewards.

Losses from overstocking can happen when inventory is purchased from the supplier on credit and you are unable to pay on time, thus forcing you to borrow cash from your relatives and friends often at high interest rates. When the payment for the loan becomes due, you get



so pressured to raise cash that you are forced to cut your selling price just so you can get rid of your inventories. When this cycle goes on and on without your noticing it, you are actually incurring real losses from interest costs and lower gross profits—a situation that could lead to a serious cash flow problem.

SO HOW DO YOU MANAGE YOUR INVENTORY BETTER?

Every entrepreneur, regardless of size of business, needs to understand the importance of efficient inventory management. When we say efficient management, it doesn't mean that inventory must be kept at low levels at all times; doing that could actually be detrimental to your company in terms of lost sales and missed opportunities. What it means is that there should be a system that could enable your company to balance its inventory requirements.

Depending on the industry where you belong, you should identify the factors that affect your inventory demands so you can control and manage them better. To begin with, demand for inventory is affected by seasonal factors. For example, since retail sales are expected to be weak right after the Christmas season, you may need to relax your inventory-buying during the first quarter of the following year. By the second quarter, though, you

may need to start building your inventory in anticipation of the summer season.

In managing inventory, you need to consider the average turnover period of your products. Some items move quickly, others move only after some time. Because different items are bought by different buyers, not all of your merchandise would have the same inventory turnover. You can compute your inventory turnover by dividing your cost of sales by the average inventory. The cost of sales is the cost of the products you sold during the period; the average inventory is the average of the beginning inventory and the ending inventory.

For example, assume that your sales for the month was P500,000 and that your cost was about 40 percent of it, or P200,000. If the balance of your inventory at the start of the month was P100,000 and your inventory at the end of the month was P75,000, your average inventory would be P87,500. To compute for the inventory turnover, you simply divide P200,000 by P87,500, which gives you 2.29 times. This figure means that you sold more than twice your average inventory during the month.

To convert this ratio into turnover days, you simply divide 30 days by 2.29 to give you the average turnaround time, which is 13 days. This figure suggests that on the average, you are able to sell out your inventory every 13 days.

With that information in mind, you can manage the lead time of merchandise delivery. You can determine your ordering day by deducting the lead time from your turnover period. If it takes five days for your supplier to deliver after you place your order, you can compute the ordering day by deducting 5 days from the turnover period of 13 days to give you 8 days. In this example, you can order your merchandise every 8th day of the average turnover period. This way, you can receive the new purchases at a time when you expect your old inventory to be sold out.

Different industries have different turnover periods. There are situations when the payment term is less than the average turnover period. When you know your inventory turnaround time, you can have a rough idea of how to negotiate your terms so you can properly control and manage your inventory level. If you are just starting in the business and you still don't have any idea of your turnover period, it may be good to establish benchmarks by spending some time researching and determining the industry average turnover period. You can then use this as basis for your negotiations with your supplier.

When your actual ratio is benchmarked with that of the industry, the industry average turnover period is also a good perfor-

mance measure. If you are underperforming against the industry standard, you may need to consider reducing your inventory level. You can do this by eliminating slow-moving products and obsolete items or by simply increasing your sales.

When you are intimately familiar with the behavior of your inventory levels, you have the advantage of managing your inventory level more efficiently. You can anticipate changes in product demand ahead of time and at the same time control your costs and manage your cash flows better. Indeed, creating an efficient inventory system is the ultimate key to your business success. ■

MR. ENTREP SAYS:

Use your turnover period to work your terms with your supplier



You can also use the turnover period as your basis for determining terms with your supplier. Ideally, the payment terms

should be at least equal to or greater than your turnover period. Under this example, you can negotiate with your supplier that you will settle your account after 15 days. In this scenario, you need not shell out cash to purchase the inventory. Instead, after you dispose of all of your inventories in 13 days, you can use the proceeds from your sales for some other purpose.



Managing payables

Have you ever wondered why you sometimes experience cash shortages even if your business is booming? No matter how much money your business generates, perhaps you always feel that you are always short of cash every

time your suppliers come knocking on your door. The cause of the problem may be poor accounts payable management. When managing cash flows, therefore, you should remember that timing your accounts payable payments is as crucial as collecting your accounts receivables.

You can manage your accounts payable better by stretching out the payment terms as long as possible without damaging your credit standing with your suppliers. There are some business owners who pay their payables too early simply because they have so much cash in the bank, but what they don't realize is that they are losing the opportunity to earn extra interest income from their cash. On the other hand, there are entrepreneurs who pay their suppliers too late and end up being slapped with penalties and charges. It is thus important that you manage your payables to the best interest of both you and your suppliers.

As a general guide, you can determine your days payable outstanding by first computing your payable turnover. For example, assume that your accounts payable at the start of the month was P150,000 and that during the month, you made total merchandise purchases of P250,000. After one month of operation, you found out that the balance of your accounts payable by month's end was P100,000. To compute for the payable turnover, you need to divide your total purchases of P250,000 by the average accounts payable of P125,000, giving you a ratio of 2.0x. This ratio simply tells you that you are paying for your purchases twice a month. To get the number of days payable outstanding, divide 30 days by the ratio 2.0. This will give you the average of 15 days.

What this means is that on the average, it takes about 15 days for you to pay your suppliers. With this information on hand, you can now check how many days it takes you to sell your inventory and collect all your receivables. Ideally, the total number of days of inventory and receivables should not exceed your days payable outstanding; this way, you would receive all cash collec-

tions just in time when you are about to pay your suppliers.

In this example, let us say you can convert all your inventories into cash in 12 days. This would mean that on the 12th day, you would already have the available cash to pay your suppliers and enjoy three more days before your accounts payable becomes due. You can then take advantage of this by depositing the cash in an interest-bearing bank account.

Sometimes, to encourage you to pay early rather than on the due date, suppliers may offer you a trade discount of, say, 2 percent if you pay within 10 days for an account payable due in 30 days. In gener-

MR. ENTREP SAYS:

When business is slow, stretch out your credit terms with suppliers



If business is slowing down and you are finding it difficult to unload your inventory and to collect from your customers,

you may consider stretching out your credit terms with suppliers. From the same example, if the number of days to convert your inventory to cash is rising to 18 days from 12 days, you may need to negotiate your credit terms with your suppliers, for instance by having the term extended by at least three more days up to 18 days to protect your cash position



al, trade discounts are good because it allows you to take advantage of it to lower your purchase costs. But there are times when trade discounts are not favorable. How would you know if it is good or not?

You can do this by computing the effective interest cost on the assumption that you are going to borrow the money to pay your account in 30 days. You then should compare this to the prevailing borrowing rate from the bank. The formula for effective annualized interest cost is $EAI = (\text{discount} / 100 \text{ percent} - \text{discount}) \times (365 / \text{payment period} - \text{discount period})$.

Suppose the prevailing borrowing rate is 16 percent per annum and you are offered a 2 percent discount if you pay in 10 days an account that is otherwise payable in 30 days. Using the above formula, we will find that the effective annualized interest cost is 37 percent as compared to only 16 percent, so it is wise to take advantage of the discount. If you have negotiated your credit terms to 60 days, your effective interest cost would be 14.9 percent, lower than the prevailing bank rate of 16 percent. In this case, you can afford not to take the 2 percent discount because it is cheaper to stretch out your payment.

It is perfectly all right for you to control the terms of accounts payable so they are to your advantage. It will also be helpful if you can put a monitoring system where you can sort all accounts payable that will soon be due; this way, you will know just how much cash you will need to prepare to pay your suppliers on time. ■

ad 5 (ibc)