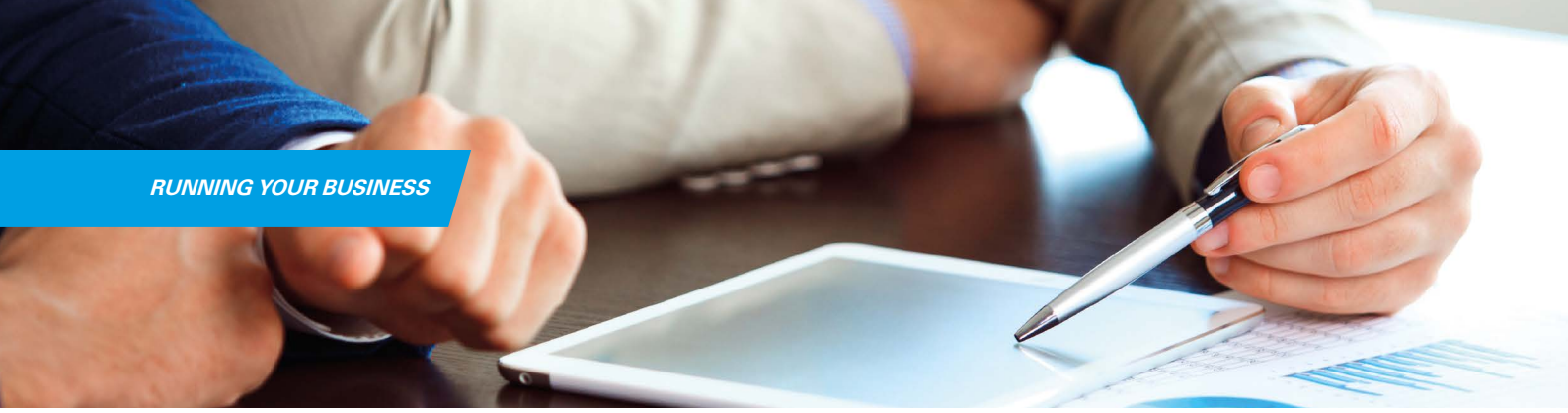
KPMG

# RUNNING YOUR BUSINESS

## The KPMG Small Business Accounting guide: Running your business





# BOOKKEEPING AND ACCOUNTING

Keeping up-to-date and accurate accounting records is more than a legal requirement. It's key to keeping track of your expenses and income and understanding where your business stands financially.

## What is bookkeeping and accounting and why is it important?

Bookkeeping simply means keeping a record of your company's financial transactions. This includes sales, expenses, salaries and other bank transactions. Your bookkeeping records form the basis of the statutory financial statements you submit to Companies House annually.

You can also use your records to produce management accounts focusing on specific areas. For example, you can prepare a breakdown of where your revenue is coming from or a comparison of budgeted expenses against actual expenses.

## Should I do the bookkeeping myself?

Doing your own bookkeeping at the beginning can be a good idea. You'll learn a lot about your business and save money. The drawback is that it can take up a lot of time. You might also miss out on tax benefits or fail to meet all your legal requirements simply because you don't know about them.

As you grow, outsourcing your bookkeeping and accounting to an accountant is an option. With outsourcing, you can be confident of meeting all your compliance requirements and of taking full advantage of any potential tax incentives. You are also free to focus on developing your business.

Outsourcing doesn't always scale up well as your business grows, so this might be a temporary measure before you employ a finance team. In an established business, this would typically include a Finance Controller (FC), a Chief Financial Officer (CFO) and team of accountants with responsibility for different financial areas.

# BOOKKEEPING AND ACCOUNTING

## What does bookkeeping and accounting involve?

Here's a list of the tasks that you typically need to get done.

| What needs to be done | Frequency |
|---|---|
| Bookkeeping<br>/ Posting transactions into accounting system<br>/ Paying bills<br>/ Chasing outstanding debtors<br>/ Payroll processing | Daily/Weekly |
| Prepare management accounts<br>/ Profit and loss<br>/ Balance sheet<br>/ Cash flow forecast | Monthly/Quarterly |
| Submitting VAT returns | Quarterly |
| Preparation of statutory financial statements | Annually |
| Corporation tax calculations | Annually |
| Claiming tax reliefs | One off |

## What sort of accounting software can I use to help?

You can choose between desktop accounting software such as Sage or cloud-based online software. Desktop-based software is generally more cost effective; there's just a one-off initial cost while for cloud-based software you pay a monthly fee.

However, more businesses are switching to online solutions like Xero because they like the way these solutions can automate a lot of accounting tasks. For example, you can pull together a record of all your purchases into a VAT return. You can also sync your bank account with your accounting system so that your banking transactions are automatically posted to the right category in your accounts.

"Keeping accurate accounting records is key to understanding where your business stands financially."

# BOOKKEEPING AND ACCOUNTING

## What else should I know before I get started?



## Accrual accounting

There are two methods of accounting: cash accounting and accrual accounting. With cash accounting, you record transactions when cash is actually exchanged. With accrual accounting, you record transactions when they occur rather than when money changes hands. This gives you a much clearer picture of the financial health of your company.
In practice, most SMEs use cash accounting for internal use and switch to accrual accounting when they prepare their annual statutory financial statements. Accrual accounting must be used for statutory financial statements to adhere to accounting standards.

Here's an example of how accrual accounting works. You've hired a freelance developer in September and estimate she has worked 10 hours in the month for an hourly wage of £100. At the end of September, she hasn't submitted her timesheets so you don't pay her, but you should record what you estimate to be the right expense of £1,000.

## Matching principle

So that your accounts give an accurate picture of how you are putting money to work in your business, you also have to match the cost of buying an asset with the period when you will use it to generate income. For example, when you buy a tablet, you expect it to help drive your revenue for as long as the tablet lasts. So, in your accounts, you spread the initial cost of the tablet over that period. This is where the concept of capitalisation and depreciation comes into play.

Let's look at the example in more detail. Say you have bought a tablet for £1,200. As you expect the tablet to also drive future revenue, you are allowed to capitalise it in your accounts and then depreciate it according to its useful life of say, two years. This is to say that you can include it as an asset in the balance sheet and then spread the costs over its useful life of two years. Instead of incurring a loss of £1,200 when you make the initial purchase, only £50 is charged to your monthly profit and loss until the tablet is fully depreciated.

This is also one of the reasons why your accounting profit can be very different from your cash position. When you buy the tablet you will have £1,200 less cash, but your accounts will only show £50 of loss in the month.

# RECORD KEEPING

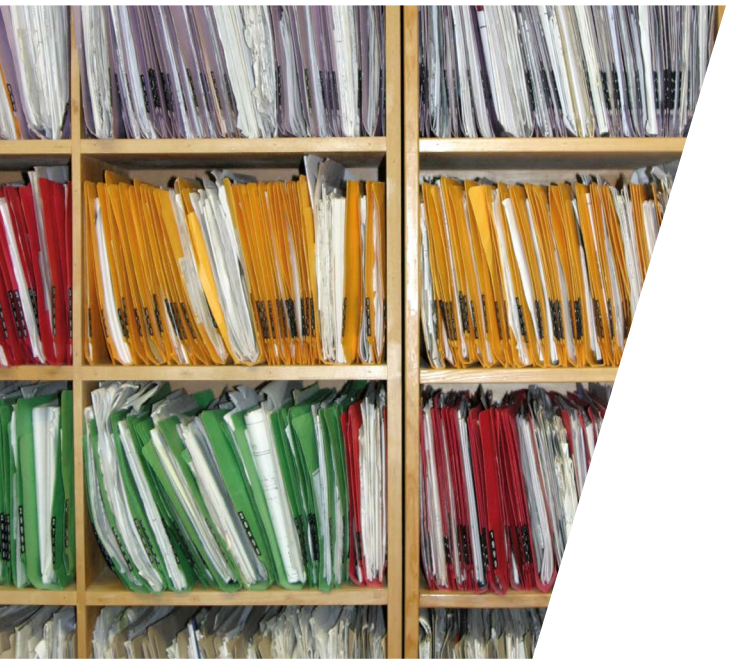
Regardless of what company structure you adopt, you will have to keep accurate company, accounting and tax records. Penalties for not keeping proper records are high and falling foul of the law does your company's reputation no good either.

Companies House and HMRC have a right to inspect your records at any time so store them in a safe place, like your registered office address. You can keep the original documents or scan and store them electronically.

There is significant overlap between the information that you need to maintain for Companies House (if you are registered) and HMRC. Generally, the records you need to keep for HMRC are also applicable for Companies House.

## What records do I need to keep?

HMRC requires you to keep an extensive set of records to back your tax returns. How long you need to keep the records for varies depending on whether they're to do with corporation tax or Pay As You Earn (PAYE).



## Record-keeping for corporation tax

### 1 / What records do I need to keep for corporation tax?

Records for corporation tax include sales invoices, purchase receipts and bank statements. Basically, you must keep hold of all the documents that provide evidence of your income, expenses, assets and liabilities.

The HMRC guide to corporation tax includes a complete list of records you need to keep.

### 2 / How long should I keep corporation tax records for?

For corporation tax, you need to retain your records for six years from the end of your accounting period.

### 3 / What's the penalty for not keeping records for corporation tax?

Not keeping records to support your tax return could see you pick up a penalty based on a percentage of the extra tax due:

/ If HMRC finds a mistake in your return that's happened because you haven't kept adequate records, you could pay a penalty of up to 30% of the extra tax due.

/ If you've made a deliberate misstatement, you could pay a penalty of up to 70% of the extra tax due.

/ If you've tried to conceal the misstatement, you could pay a penalty of up to 100% of the extra tax due.

# RECORD KEEPING

## Record-keeping for PAYE

### 1 / Why do I need to keep records for Pay As You Earn?

You need to keep accurate payroll records so HMRC can make sure that:

/ You and your employees are paying the right amount of tax and national insurance contributions (NIC)

/ Your employees are getting any statutory pay they're entitled to

/ You're complying with the law.

### 2 / What records do I need to keep for PAYE?

The records you need to keep include:

/ Pay, tax and NIC records

/ Statutory Sick Pay records

/ Statutory Maternity, Paternity and Adoption Pay records.

The HMRC guide to PAYE record keeping (see page 70) gives full details of the records you need to keep.

### 3 / How long should I keep PAYE records for?

You need to keep records for the current and previous three tax years.

### 4 / What's the penalty for not keeping accurate PAYE records?

Failing to keep accurate records could see you pay a penalty of up to £3,000.

"HMRC requires you to keep an extensive set of records to back your tax returns. How long you need to keep the records for depends on whether they're to do with corporation tax or Pay As You Earn."

# BUILDING A FINANCIAL MODEL

Financial modelling might sound like the stuff of high finance. In fact, it's a practical tool that can help you make smarter decisions about your business' future. This can include anything from working out when you're likely to become profitable to understanding how different funding options could affect your business.

Once you've set up a model, you can use it to test different scenarios, to find out the impact of falling or rising costs on future profits, or to look at the impact of proposed new borrowing on cash flow. Lots of companies use their models to calculate 'base case', best case and worst case, giving them a full picture of possible outcomes.

## Where do I begin?

The first thing to get clear is: what do you want your model to show? If the model is for an investor, the easiest way to do this is to ask the investor what they want to see.

List out all your inputs and assumptions, including working capital, currency, tax, revenue and relevant time periods. Take time to get these right as changing them further down the line will be time-consuming.

Consider your corporate structure; are you financed by equity or debt? If you are financed by debt, you may need to build covenants and debt seniority into your model.

Separation

Consistency

Linearity

Integrity

Simplicity

## Separation

/ Keep your input, output and calculation worksheets separate and label each worksheet clearly. This makes it easier for the user to understand the variables driving the model.

/ Don't hardcode inputs and formulas. If you change your assumptions you'll struggle to find the formula.

/ Colour code your input cells so you can identify the input sources.

/ Document your model as you build it by keeping an assumptions book and a log of all model changes.

## Consistency

/ Keep formatting consistent for cells of the same type. It makes the model look professional and adds credibility.

/ Across all worksheets, use the same time period in the same column. Keep the time periods consistent and keep the formula constant across each row. Don't change a formula part of the way through a year, row or column.

/ Use consistent sign convention. Income, assets and cash inflows are all positives. Expenses, liabilities and cash outflows are all negative.

## Linearity

/ Ensure formulas flow from top to bottom, front to back. There should be no circular references or iterative calculations as this adds unnecessary confusion to the model.

/ Don't use links to external workbooks. They often result in outdated data and a flood of error messages.

# BUILDING A FINANCIAL MODEL

## Integrity

/ Best practice is to produce full financial statements (profit and loss, balance sheet and cash flow forecast). Make sure your outputs are in line with accounting standards: your balance sheet should balance and your assets should equal equity plus debt. Don't use balancing figures or fudges.

/ Use checks to ensure internal consistency of data. Try to set up a network of error checks, so that if there is an issue on one sheet, it affects other sheets.

## Simplicity

/ Keep your model simple and formulas short. Avoid unnecessarily complex functions and macros wherever possible.

/ Don't conceal rows or columns as it is not immediately obvious to the user that there is information hidden.

## How can I tell if my model does the job?

Models are risky by nature, so testing is key. According to the FAST Standard Organisation (FSO), at least £70 million is wasted each year because employees cannot interpret the different financial models used by different departments. A full audit of your model can help cut out problems like this.

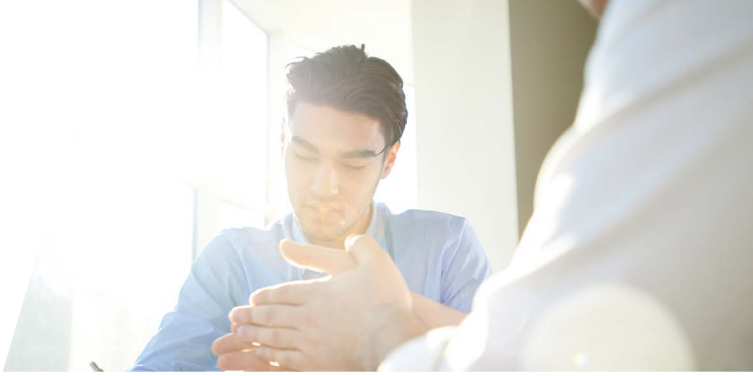
/ Get a peer or friend to give the model a robust work-out.

/ Analyse every unique formula.

/ Give your model to the people who will be using it and ask them if it produces the outcome they want to see.

## Am I ready to start using my model?

Yes. But don't forget that while every model is different, they all have one thing in common: rubbish into the model equals rubbish coming out. Make sure the assumptions you feed into your model are reasonable and can be justified.



# WRITING A BUSINESS PLAN

A clear and well laid-out business plan is essential when it comes to raising finance or as a road map for developing your business and planning budgets. You'll find that your plan will change constantly but preparing one is still a good way of organising your ideas.

## This section of the guide covers the five most common elements of a business plan:

- Executive summary
- Business overview
- Sales & marketing strategy
- Operations and management
- Financial information

## Executive summary

The executive summary gives an outline of the business plan. It's the first thing people will see, so it should include key facts and, most importantly, tell the reader what you want from them (don't bury your key message in a table on page 5!). It should cover the business concept, financial requirements, current business position and major achievements.

## Business overview

Start by describing your industry and where your business fits in. When you describe the industry, it's useful to talk about the present and future direction. Include information on markets and other products in the industry to give investors the information they are looking for and to help you get clearer on the market and the competition. Make sure any industry statistics you use are based on reliable market data as this adds credibility. Indicating your sources in footnotes is an easy way to put this across.

When you describe the business, focus on its structure. What type of business is it? Manufacturing, software, consumer goods, wholesale, retail? Explain who the target customers are, what distribution channels you will use and what support systems, such as advertising, promotions and customer service, you have or plan to develop.

Next, talk about the products or services you offer. Make your description concise and to the point, but give the reader enough detail to understand where the competitive edge lies. Add weight to your description by emphasising how your product or service is unique or different from current products in the market, especially if the current products are successful.

# WRITING A BUSINESS PLAN

## Sales & marketing strategy

The analysis you do to develop your sales & marketing strategy will force you to get to know all aspects of your market. This will help you define your target market precisely and position your business to grow.

Key questions your sales & marketing strategy should cover include:

/ What is your overall market?

/ What is your projected market share?

/ How do you want to position your business in the market?

/ What is your pricing strategy?

/ What distribution channels will you use?

/ How do you plan to promote the product/service?

/ What is the potential for sales?

/ Who is your competition and how are you different from them?

## Operations and management

Think of the operations and management plan as the plan for how your business will function. There are two key areas you need to address: the organisational structure of the company and the capital and expense requirements of the operation.

### Organisational structure

The organisational structure is often used as the basis for projecting salary costs (usually the largest operating expense for a company), so this part of your business plan is key. The organisational structure is critical to the formation of financial statements, which are heavily scrutinised by investors. So make sure your structure is well defined and realistic given the parameters of the business.

### Capital and expense requirements

The idea is to capture all your capital needs for large purchases and all your on-going expenses in order to estimate how much it will cost to run the business.

## Financial information

Investors will look carefully at the financial information you include, not only to see how the business is doing but to find out how much of a handle the management team has on the business. Including detailed financial forecasts and showing that you have considered different scenarios and sensitivities will demonstrate to investors how competent your management team is.

Typically, the financial information included in a business plan includes a cash flow statement, an income statement and a balance sheet. Consider presenting the funding proposal in the form of a timeline and perhaps touching on the exit strategy to increase investor interest.

# MANAGING WORKING CAPITAL

Not having enough capital to cover everyday running costs is the number one cause of failure for SMEs. So managing your cash flow needs to be one of your top priorities.

For a typical business, everyday costs include payments to utility providers and suppliers, and business overheads like salaries and rent. Making sure the cash in your bank account matches your working capital needs is the essence of good working capital management.

## Where do I begin?

The key to managing working capital is budgeting. Make sure you have a firm plan in place showing how the business will maintain sufficient cash flow. The plan is to identify potential hazards early enough to give you time to put things right.

Think about whether your approach to cash management gives you a clear enough picture of how money is flowing in and out of your business. Can you forecast cash flow for both the short term and the medium term? How accurate is your forecasting? And are there hidden risks and dangers that need to be brought to light?

Performing a cash flow forecast on a regular basis is a useful way to identify your capital needs. Once you understand the financial cycles of your business, you can set aside the right amounts of working capital to meet your current goals and prepare for future ones.

## How can I improve cash flow?

Start by thinking about how long it takes you to receive the money you're owed. If you haven't collected the cash for a sale, you haven't completed the sale.

To streamline cash flow processes, send out invoices as soon as possible after you've sold a product or delivered a service and keep the time you have to wait for payment short. Collecting debt is key – the longer it takes for debtors to pay you, the longer you have to finance that sale.

Don't forget that cash flow is about cash that goes out of your business as much as about cash that comes in. Identifying areas where you can reduce outgoings will help you keep more cash in your business.

## How do my credit terms affect my cash flow?

Negotiating the right credit terms with your customers is vital to ensuring a regular cash flow. Credit terms should be set for customers based on their financial strength and their history. Keep these terms under constant review as one large bad debt could sink the business.

When it comes to paying suppliers, try to stagger your payments to suppliers and negotiate more favourable payment terms so that you can keep cash in the business for as long as possible. Ideally the credit terms you negotiate with suppliers should be longer than those you grant to customers.

A good example would be 30 days for suppliers and 15 days for customers. This way, you'll receive the cash from sales 15 days before you need to pay debts. This may not always be possible for an SME but it's a good model to aim for.

# MANAGING WORKING CAPITAL

## How can I free up cash locked away in invoices?

Invoice factoring and invoice discounting are two options for freeing up working capital locked away in invoices.

### Invoice factoring

'Invoice factoring' involves an invoice financier managing your sales ledger and collecting money owed by your customers. The financier will make most of the invoice value (around 85%) available to you up front. The remaining money (less interest and fees) will be made available to you once the financier has collected from the customer.

### Invoice discounting

Invoice discounting is when an invoice financier lends you money against your unpaid invoices, but doesn't manage your sales ledger or collect debts on your behalf. Invoice financiers tend to focus on commercial invoices, so if you sell directly to individual customers, you probably won't be eligible.

With invoice discounting, you usually receive an agreed percentage of the invoices' total value. As invoices are paid, the money goes to the invoice financier, which reduces the amount you owe them. This means you can then borrow more money on invoices from new sales if necessary.

Fees for invoice discounting tend to be a little lower than for invoice factoring because the financier is not managing your ledger.

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**Your personal KPMG accountant:** There are times when you need to speak to someone with a real understanding of your business. Our service provides you with a dedicated accountant and the expertise of one of the world's biggest networks of business advisors.

**Instant real-time access to your business performance:** Our flexible cloud-based service gives you real-time access to your numbers: helping you to identify funding needs and manage your cash flow

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