

Enterprise Development Training Course

DAY TWO - SESSION EIGHT

The Practical Use of Simple Business Figures

Objective: to enable participants to make use of simple accounting figures in order to identify problems and recommend solutions to real business problems.

Time: One and a half to two hours.

Material:

Copies of the following handouts for all participants:

- Mary the shopkeeper
- Ali the carpenter
- Simple financial analysis for micro-enterprises

Session Guide:

1. Remind participants that tomorrow they will have to apply what they are learning about accounts in the classroom to real businesses in the market. The figures will then not be clearly and unambiguously presented to them. They will have to obtain them from the business people, identifying and trying to fill any gaps, and then putting the figures into the format of the 'still' and 'moving' pictures, in order to be able to use them to advise the owner of the businesses.

This session will be 'half-way' towards that real-life situation. We shall be dealing with three case studies, where figures will be provided in a realistic way, i.e. in no particular order, and perhaps with some gaps. Participants will have to put the figures in order, identify and try to fill any gaps and then analyse the completed statements and make suggestions as to possible improvements in financial management.

2. Distribute 'Mary the shopkeeper'. Allow up to ten minutes for participants to try to complete this on their own and then encourage those who have not been able to finish, to seek advice from their possibly more experienced neighbours. It is important that they should first try on their own though.

After a further five minutes ask one participant to tell you what format to put on the board, into which you will then put the figures. Elicit the necessary headings for the 'still' and the 'moving' pictures' of Mary's business and put them on the board, without any figures.

Then go round the class asking each participant in turn to suggest where one figure should be written into the format you have prepared. Be sure not to allow one participant to give all the answers, since the objective is to make sure that even those with no previous knowledge of accounting are able to test and demonstrate their newly acquired skill.

3. The final figures should be as follows:

Still Picture of Mary's Shop on 31 December 2003

Uses (\$)		Sources (\$)	
Cash	50	Mary's money	200
Owed to business	200	Owed to supplier	100
Stocks	400	Loan	100
Bank savings	350		
Total	1000	Total	400

Moving Picture of Mary's Shop for the month of December 2003

	\$
Sales	500
Less Cost of what was sold	400
PROFIT	100
Personal drawing	50
Retained profit	50

4. Ask participants to suggest why the two columns of the 'still picture' do not balance; what figure is missing?

Elicit the answer that if the other figures are correct and there are no other missing items, the balance of \$600 must have come from profits which Mary left in the business.

What other information is there which suggests that this may indeed be the correct figure?

The retained profit for one month is \$50 and the business has apparently been operating at a similar level for twelve months. It appears therefore that Mary has, without being aware of the fact, reinvested \$50 a month in her business for twelve months, giving a total reinvestment of \$600.

Point out that this is one way in which very simple accounts of this kind can be used to find out about the past history of a business. If the total value of what the business owns is well in excess of the sources that can be identified, this means that the owner has reinvested the profits. This is in fact the main source of money for most businesses once they have been going for some time.

Ask participants what other factor apart from reinvested profits can increase the value of what a business owns so that it far exceeds the identifiable sources. Inflation increases the value in money terms, and money is the only 'language' we have to compare values of different things. If a business bought a small building for \$200 in 1990, for instance, it might be 'worth' \$1000 in 2000, but this increase in value is in fact mainly caused by the reduction in the real value of money, not by an increase in the real value of the building. Inflation means that accounting figures are a less reliable way of assessing business results over a long period, and participants should be aware of this factor if the businesses they are assessing are more than a few years old.

5. Remind participants that the purpose of learning how to produce these figures is not to pass an exam. They are tools for understanding businesses and assisting yourself or others to manage them better, and if they are not used for this it is a waste of time to learn them.

The calculation of reinvested profits (or accumulated losses) is useful to assess the past performance of a business and to help its owner recognise her success or her failure. There are many other ways in which we can use even very simple figures such as we have now produced for Mary's business to assess the financial management and to make suggestions for improvement.

Ask participants what other comments they can make about the way in which Mary is managing the money in her business. Does she appear to be allocating her money sensibly?

Some participants may be familiar with 'accounting ratios'; point out that every business is different and there are no standard rules as to the correct relationships between amounts of money being used in different ways in a business. Ask participants to examine the figures in the 'uses' column; what can they learn from them about Mary's financial management?

Participants may comment on the figures for stocks or for money owed to the business. Stress that the figures mean nothing unless they are related to other figures. What should these figures be related to?

Stocks (\$400) should be related to the cost to the business of the goods sold each month (also \$400). What does it mean that they are both the same?

- Mary's business has stocks for one month of sales; this might be too high for a shop selling perishable goods and too low for a shop selling goods which are in short supply or where customers need to be able to see a wide range, but for a village general shop it is probably right.

Money owed to the business (\$100) should be related to the sales in a month (\$500). What does this relationship mean?

- Mary is giving credit for one fifth of a month, or less than a week; as with all figures, this average may conceal a small number who owe for far longer periods, but the average seems reasonable.

Elicit comments on other relationships such as:

Money owed by the business (\$100) compared to the cost of goods sold each month (\$400)

- This means that Mary's business owes the cost of supplies for one quarter of a month, or about one week.

Profit margin (\$100) compared to sales (\$500)

- This means that Mary is making a margin of one fifth, or 20%, on her sales; for every dollar of sales, she earns twenty cents towards her personal and other expenses.

Retained profit (\$50) compared to sales (\$500)

- This means that the business makes 10% profit after personal drawings or ten cents for every dollar of sales.

Cash (\$50) and savings (\$350) compared to debts (\$100 owed to supplier and \$100 loan)

- This means that what accountants call the 'liquid assets', that is, items under 'uses' which could, if necessary, be used immediately to pay off the debts of the business, or its 'current liabilities', add up to \$400. This is well over the total of \$200 owed by the business to its supplier and to Mary's brother, so she could if necessary pay these debts and still stay in business.

Ask for comments on these 'ratios'. In general, they suggest that Mary is making good use of her money.

6. Distribute copies of 'Ali the carpenter'. Allow participants fifteen minutes, at first on their own as before, to try to complete the assignment, and then encourage them to discuss it with one another.

Elicit the figures as before, by asking each participant to deal with one item. The completed 'still' and 'moving' pictures should be as below. The details of sequence and layout are not important, if participants wish to have the 'sources' column on the left and the 'uses' column on the right, or if they prefer any particular sequence for the figures in each column, be guided by them. Do not try to impose the format - what matters is that they all understand the substance.

'Still' Picture of Ali's Carpentry Business on 31 December 2003

Uses (\$)		Sources (\$)	
Cash	100	Ali's money	1000
Stocks - wood	500	Owed to supplier	500
Stocks - furniture	1000		
Owed by customers	1500		
Equipment	500		
Building	900		
Total	4500	Total	1500

'Moving' Picture of Ali's Carpentry Business for the month of December 2003

	\$	\$
<i>Sales</i>		
Furniture		500
<i>Expenses</i>		
Cost of wood and other materials	200	
Helper's wage	60	
Transport	30	
Tea and snacks	20	
Total expenses		310
<i>Profit</i>		190
<i>Personal drawings</i>		240
<i>Retained profit (or capital reduction)</i>		(50)

7. Ask for comments and initiate a discussion. The following points should be covered:

- No allowance has been made for 'depreciation' or the decline in value of the equipment. Explain that businesses such as taxis or large companies with very costly equipment, which wears out or becomes out-of-date very quickly, should include some allowance for this in their expenses, to avoid over-stating their profits and to make sure that they are able to buy new equipment when it is needed. This is probably not necessary for very small businesses with very modest equipment, such as typical NGO clients, particularly because items such as carpenters' tools usually increase in value because of inflation faster than they decrease because they wear out.
- The business appears to have reinvested profits of \$3000 (\$4500 minus \$1500) but inflation in the value of equipment and the shed has probably caused some of this; the business may have been making profits in the past, but it is not keeping up with personal drawings now.
- The business has stocks of raw materials for two and a half months (\$500 stocks, \$200 used monthly); this is probably too much.
- The business has stocks of finished furniture for two months of sales (\$1000 stocks, \$500 sold per month); this is also probably too much.
- The customers owe the business three months of sales (\$1500 owed, \$500 sold per month); this is too much.
- Ali is paying himself a salary based on what he believes somebody with his skill should earn, rather than what the business can afford.
- The margin which Ali is adding over the cost of materials is one and a half times or 150% of the cost of the materials themselves (Margin \$300 vs. materials \$200). This may be normal, but it seems high for simple furniture. If the margin is higher than Ali's competitors', it may mean that his prices are too high, which would explain the low sales and the resulting inadequate profit.
- The workload may not justify the employment of a helper. Advisers should not discourage employment, but it is even more important that businesses should not lose money; this is not in anybody's ultimate interest.
- Tea and snacks are pleasant but not essential; they should be paid for from personal drawings and not from the business, particularly a business which is losing money.

- Some participants who are still more oriented towards larger formal businesses may say that items such as income taxes have been omitted. If they do, explain that for small businesses this would be part of personal drawings anyway but the really small enterprises, which are the focus of this course, are usually far beneath the attention of income tax authorities.
8. Distribute the handout 'Simple financial analysis for micro-enterprises'. Participants should read this through and be sure they understand it. They may also find it useful for analysing the figures they are to obtain from their visits to enterprises the next day. The 'ratios' are not given in the form of formulae, since participants should not try to memorise them. The purpose is to understand them and to identify situations where they may be useful.

These and other points show how much can be learned from a few simple figures. Stress that such figures do not in themselves suggest what a business owner should do - they merely suggest questions that should be asked. There may be special circumstances such as shortage of supplies, competition or other reasons which fully justify all the apparent management mistakes identified above. Tomorrow participants will have to elicit whatever figures they can and then ask appropriate questions in order to give useful advice.

Note:

Some participants may want handouts to remind them of the correct figures. It is better to ensure that they have all worked out and written down the correct figures for themselves; people learn more from what they have done for themselves than from papers that have been prepared for them.