# Module 1: Starting Out

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# Contents



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# Introduction

The purpose of this first module is to take you through the thought process of setting up a brand new business. It broadly addresses two issues:

- Do you have a viable business idea? It achieves this by taking you through the process of constructing a financial forecast for the first few years of your business. Fundamentally if your business idea won't make a profit then it can't support itself, let alone you.
- What are the mechanics of setting up a simple business? This section takes you through all the details you need to consider in getting your business off the ground.

It is worth stating at the outset that this toolkit is designed to give generic business advice and descriptions. It can never be a substitute for the sort of detailed, company-specific advice you will receive from a lawyer, accountant or other business professional. At some point in the formation of your business you should take proper professional advice to ensure you stay within the precise rules and regulations that relate to your particular business.

# Finance and your first forecast

## Purpose of the module

This module will outline what we mean by finance and why we need accounts. The majority of the module will then take you through the process of putting together your first forecast and will cover the range of financial issues that you need to think about before setting up a business.

# What is finance for and why do we need accounts?

Accounting is fundamentally about telling the story of a business from a financial perspective, i.e. what do all the financial transactions actually mean? It is easy to collect a box full of invoices – but it is the purpose of the accounts to group those invoices into categories so you can tell what is going on.

Understanding this financial story is a key component of running a business – you need to think about finance as you start to plan your business because:

- Keeping accounts is a legal requirement, if you are a full limited company you must file annual accounts at Companies House, even if you are just a sole trader (operating a small business at the same time as a 'regular' job) you still need to keep detailed accounts to calculate how much tax you need to pay.
- Even before you start your business you need to forecast your financials to see if it is viable and will make you enough money to pay you a wage, or even to make you rich!
- This simple act of forecasting will help you think through each aspect of your business in detail and avoid missing something fundamental. It will also help you understand the dynamics of how your business is going to work.
- Once the business is up and running you'll need to keep detailed accounts to track the progress of your business, compare the results to your forecast and take corrective action if needed.

# Your first forecast

The intention of this module is to consider the first steps of a simple company. We'll stick to something called a "sole trader" for now which simply means a one-person operation, perhaps setting up their first business or doing it alongside an existing job. We'll consider more complex business structures such as a Limited Company in module 2.

The aim in the rest of this model is to describe each component of your first forecast. We'll be constructing a forecast for the first three years of your business. This is long enough to think beyond the start-up phase to the point when your business is established. We'll consider the longer term in later modules.

The forecast will generate a profit and loss account (your sales less costs) and also a cash flow which will enable you to identify how much cash you need to get your business up and running.

If you have any experience of accounting you may wonder why we are not including a balance sheet. If you were preparing full published accounts (known as statutory accounts) you would do so, however for the purpose of assessing your business viability the two most important numbers in the balance sheet are profit and cash, and we will be generating these. The remainder of the balance sheet is somewhat academic if you are making a loss or running out of cash.

In describing each of the key financial areas you need to consider this module encourages you to understand and think through the financial drivers of your business. It does not attempt to provide the sort of detailed situation-specific professional advice you would get from a lawyer or accountant; it can never consider the precise circumstances of you and your business. The legislation surrounding taxation, employment, health and safety, food standards and so on is complex and as there are significant risks of non-compliance, you should therefore ensure that you thoroughly research the relevant legislation and regulation for your business environment and take appropriate professional advice where relevant.

## Sales – the starting place

It's likely that the impetus for your business has started with the germ of an idea about a product or service. After all – that's what a business does – sell things,  and therefore this is the first aspect to consider. In addition, every other business decision flows from your sales – how much raw material do you need to buy, how big a factory do you need, and so on?

### Uncertainty

It's worth making the point that sales are the most difficult element to forecast accurately – if your business is new, then you have no experience of this product in this market – snail flavoured ice cream may sound lovely to you – but may not appeal to many others!

You should therefore do as much investigation as possible. Ask friends and colleagues what they think of your idea. Would they buy it and how much would they pay? Encourage them to be brutally honest. Look at your potential competitors, what are the features of their product, how much do they charge? All limited companies have to publish accounts – you may be able to get a feel for how many of a product your competitors sell by looking at their accounts. If they are a UK company then for a fee of £1.00 you can download their accounts from Companies House [www.gov.uk/get-information-about-a-company].

## Price

There are two elements you need to forecast when looking at sales: volume (the number you sell) and the price per item. These two are interlinked – if you put your prices up, you'll probably sell less. It's important to balance these two to maximize revenue (the accounting term for the money you make from selling) and profit. When considering the price you charge it's useful to think of the 4Cs:

**Costs** – obviously your price has to be higher than your costs otherwise you won't make a profit; we'll look at costs in more detail later in this module, but when you are comparing price to costs you should consider whether you need to cover variable costs or total costs.

**Customers** – simply what will, or can, your customers pay?

**Competitors** – what do your potential competitors charge, how will your product compare to theirs? You should also try to gauge what the reaction of your competitors will be to your launch. They may reduce their price to try and drive you out of business.

**Corporate Strategy** – what's your overall approach – are you attempting to be an up-market differentiator, where high prices would be what your customers will expect, or are you a cost leader attempting to be profitable through high volumes and low prices.

Finally, you should think about how your price will change over time – as you will be introducing a new product it is useful to look at two approaches you can take at the beginning:

**Market Penetration** – if you are launching a product into a crowded, mature market you may have to initially set your price low to encourage customers to try your new, unfamiliar product. Imagine a new washing powder being sold at a 50% discount. The aim here is to get customers into the habit of buying your product. There is a danger however that customers get used to your product at this low price and you will struggle to raise the price later.

**Market Skimming** – if there is something that sets your product apart from the competition you can launch it with a relatively high price. This restricts the volumes you will sell which can actually be useful if it enables you to deal with production teething problems in the early stages. This approach is particularly useful where a product has a strong image but may have a short life cycle during which you need to maximize profits – imagine the latest Apple iPhone.

### Inflation

For the purpose of your first three-year forecast you should ignore inflation. In the current economic climate inflation is low and therefore will only have a small impact over three years. Secondly inflation will impact both your sales revenue and costs so the net impact on profit will be small.

## Volume

Once you have decided on the price you should consider the quantity of each product you will sell (volume). There are many factors that influence volume including:

**Capacity** – simply how many you are able to make? At the beginning there may be teething troubles so you should assume that your volumes will increase gradually as you build up expertise.

**Price** – obviously a high price product will be more exclusive and sell in lower quantities than a cheaper one.

**The market** – how big is your potential market, how much of it is already supplied by your direct competitors, what percentage of that market, are you aiming to capture?

**Complementary/substitute products** – if you plan to have a number of different products you need to think about the relationship between them. Some will be complementary, so a purchase of one drives another (such as fish and chips), whereas some will compete for the same customer (such as a jar of jam sold in two different sizes). You need to ensure that your volume projections are consistent.

### Growth

Over the first three years you will of course be hoping that your sales volumes will grow and you should factor this in. However you should consider all of the volume issues above – you cannot for instance grow so much that you end up supplying more volume than the total market that exists! You should also consider the impact of compounding – a small amount of growth each month can lead to a very large level of growth over three years. For instance if every month you sell 5% more than the previous month – by the end of three years you will be selling SIX times more than in your first month.

### Template

The attached spreadsheet will help you build up your first forecast. You should open this and go to the Sales tab at the bottom left hand corner. You will see that this has space for you to include 5 different products with a volume and price for each. You should key in your assumptions in the pale yellow cells. As you key in the volume and price you will see that the total sales revenue is automatically calculated for each month, for each year in total and also for the full three year forecast.

The picture below shows the sheet containing some example data.

| **Company name: ABC Trading** | | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Sales** | | | | | | | | | | | | | | | |
| | **Credit** | | **Year 1** | | | | | | | | | | | | **Total** |
| | **Mth** | | **Mth 1** | **Mth 2** | **Mth 3** | **Mth 5** | **Mth 6** | **Mth 7** | **Mth 8** | **Mth 9** | **Mth 9** | **Mth 10** | **Mth 11** | **Mth 12** | |
| Product 1 | 0 | Volume | 12 | 13 | 15 | 17 | 17 | 16 | 18 | 19 | 20 | 21 | 23 | 35 | £226 |
| | | Price | £45.00 | £45.00 | £45.00 | £45.00 | £45.00 | £45.00 | £45.00 | £45.00 | £45.00 | £45.00 | £45.00 | £45.00 | |
| | | Total | £540 | £585 | £675 | £765 | £720 | £810 | £855 | £900 | £945 | £1,035 | £1,575 | | £10,170 |
| | | | | | | | | | | | | | | | |
| Product 2 | 0 | Volume | 50 | 60 | 80 | 100 | 110 | 120 | 130 | 130 | 120 | 140 | 150 | 120 | £1,310 |
| | | Price | £9.99 | £9.99 | £9.99 | £9.99 | £9.99 | £11.99 | £11.99 | £11.99 | £11.99 | £11.99 | £11.99 | £11.99 | |
| | | Total | £500 | £599 | £799 | £999 | £1,099 | £1,199 | £1,559 | £1,559 | £1,439 | £1,679 | £1,799 | £1,439 | £14,667 |
| | | | | | | | | | | | | | | | |
| Product 3 | 0 | Volume | | | | | | | | | | | | | |
| | | Price | | | | | | | | | | | | | |
| | | Total | £0 | £0 | £0 | £0 | £0 | £0 | £0 | £0 | £0 | £0 | £0 | £0 | £0 |

## Costs

Once you have established your sales you can start thinking of your costs. These are much easier to forecast than sales as you can always get quotes for the cost of an item.

Costs broadly fall into two categories – fixed and variable.

## Variable Costs

As the name suggests these are costs that vary directly with volume. Think of your raw materials, if you don't make any of your products you don't need any material, for every new product you make, you need one more quantity of raw material.

It is worth building up something known as a cost card – a list of every item you will need to make one unit of your product. The easiest way to do this is simply to use your own experience – try making the product in your kitchen keeping detailed notes of the ingredients. Even at this stage think about efficiencies – a few pence saved on every item can make a big difference to your profits.

Once you've identified your raw materials, remember to include other variable costs, such as:

- electricity – you may have to estimate, but it's better to include something rather than nothing – you can always refine your estimates as you build up more experience;
- postage/courier costs or fuel for your vehicle.

### Template

The spreadsheet has two tabs relating to variable costs. The first is called **CostCard** and enables you to build up the variable cost for each of your products. As before you should use the yellow cells to build up the costs. You can use the 'other' lines if you run out of space in the top sections. The picture below shows the cost card in the process of being built up:

| Company name: ABC Trading | | | | | |
|---|---|---|---|---|---|
| Variable Costs | | | | | |
| Cost card for each product | | Product 1 | | Product 2 | |
| | | Description | Cost per unit (£) | Description | Cost per unit (£) |
| Raw materials | 1 | Meat | £1.00 | | £0.00 |
| | 2 | Potatoes | £0.34 | | £10.00 |
| | 3 | Carrots | £0.80 | | £0.00 |
| | 4 | | £0.00 | | £0.00 |
| | 5 | | £0.00 | | £0.00 |
| | | | | | |
| Production costs | | | | | |
| Labour | 1 | Mr Smith 1 hour | £12.00 | | £0.00 |
| Labour | 2 | Mrs Jones 30 mins | £8.00 | | £0.00 |
| Labour | 3 | | £0.00 | | £0.00 |
| Electricity | | 1 unit | £0.20 | | £0.00 |
| Gas | | | £0.00 | | £0.00 |
| Machine time | | 20 mins | £0.60 | | £0.00 |
| | | | | | |
| Other | 1 | | £0.00 | | £0.00 |
| | 2 | | £0.00 | | £0.00 |
| | 3 | | £0.00 | | £0.00 |
| | 4 | | £0.00 | | £0.00 |
| | 5 | | £0.00 | | £0.00 |
| | | | £22.94 | | £10.00 |

The second tab related to variable costs is called VarCosts. This is largely automatic, it takes the volume data from the Sales tab and multiplies by the cost card for each item. The yellow cells enable you to reduce or increase the cost per unit over the three years (see the section "Changes in costs" later). The default is 100% i.e. the cost card is applied in full throughout, the example below shows costs reducing slightly over the first months as volume discounts are achieved.

| Company name: ABC Trading | | | | | | | |
|---|---|---|---|---|---|---|---|
| **Variable Costs** | | | | | | | |
| | **Credit** | | **Year 1** | | | | |
| | **Mth** | | **Mth 1** | **Mth 2** | **Mth 3** | **Mth 4** | **Mth 5** |
| Product 1 | 0 | Volume | 12 | 13 | 15 | 17 | 17 |
| | | Factor | 100% | 100% | 95% | 95% | 95% |
| Cost card | £22.94 | | £22.94 | £22.94 | £21.79 | £21.79 | £21.79 |
| | | **Total** | **£275** | **£298** | **£327** | **£370** | **£370** |
| Product 2 | 0 | Volume | 50 | 60 | 80 | 100 | 110 |
| | | Factor | 100% | 100% | 95% | 95% | 95% |
| Cost card | £10.00 | | £10.00 | £10.00 | £9.50 | £9.50 | £9.50 |
| | | **Total** | **£500** | **£600** | **£760** | **£950** | **£1,045** |

## Fixed costs

Unsurprisingly these are costs that are fixed, i.e. that don't vary as you make more or less of your product. An example would be the rent of an office or factory where you have to pay the same amount regardless of whether you make one item or one thousand.

When building up your forecast a significant difficulty is simply remembering to include every single cost of running the business and estimating the amounts. You need to think widely, if you are working look around you for everything that will cost the company money to do, discuss with as many other people as possible, especially those who run a small business. As a start remember to include: rent, rates, electricity, advertising, website, stationery, heating, postage, petrol for your car (and other expenses, tyres, MOT, insurance), phone calls, broadband, product testing and regulations, and so on.

### Semi-variable & stepped costs

There are some costs which can be semi-variable, or stepped – electricity for instance has a fixed standing charge and a per-unit element. You'll need to split these into the variable and fixed parts.

### Wages

Our first forecast is for a simple business that is unlikely to have employees, we will consider employing staff in more detail in the second module. However if you envisage employing staff their costs would be a fixed cost. You should remember to uplift their wage to incorporate employer's National Insurance, holiday pay, uniforms, training costs etc. It would be reasonable to uplift their salary by approximately 30% to cover these items.

### Template

The FixCost tab on the spreadsheet enables you to forecast your fixed costs. It is divided into two sections. The top part is for costs that you do not pay monthly, for instance if your rent is paid every quarter in advance, then you should input the payments into the yellow section; you will then see that the line below averages those costs across the year as you can see on the example below.

| **Company name: ABC Trading** | | | | | | |
|---|---|---|---|---|---|---|
| **Fixed Costs** | | | | | | |
| | **Mth** | **Year 1** | | | | |
| | | **Mth 1** | **Mth 2** | **Mth 3** | **Mth 4** | **Mth 5** |
| Non-monthly costs | | | | | | |
| Rent | | £300 | | | £300 | |
| | | £100 | £100 | £100 | £100 | £100 |
| Rates | | £50 | | £50 | | £50 |
| | | £25 | £25 | £25 | £25 | £25 |
| Electricity | | | £30 | | | |
| | | £10 | £10 | £10 | £10 | £10 |

There is then a section lower down for regular monthly costs, again input the amounts in the yellow cells.

| **Monthly costs** | | | | |
|---|---|---|---|---|
| Rent | £10 | £10 | £10 | £10 |
| Rates | £5 | £5 | £5 | £5 |
| Electricity | £10 | £10 | £10 | £10 |
| Gas | | | | |
| Other 1 | £7 | £7 | £7 | £7 |
| Other 2 | £2 | £2 | £2 | £2 |

Both parts of this tab have 10 ‘other’ lines for you to include items specific to your business.

## Costs and sales price

You may remember that earlier in this module we noted that your selling price needs to be higher than your costs so that you make a profit. It is worth at this point considering which costs we are talking about. Ideally your total revenue should be greater than all your costs, however in the first few months of operation you may sell very few items, but still have a large rent bill to pay. You should therefore at the very least ensure that your selling price is higher than your variable cost per item. This variable cost per item is also known as the marginal cost, i.e. the extra cost of making one more item.

Forecasts often contain a line called contribution which is total sales revenue less total variable cost – as long as this contribution line is positive, then as volumes increase, there will be an increased contribution towards the fixed costs below.

Traditionally large businesses included a proportion of fixed costs on the cost card for each product. In doing so they were attempting to ensure that selling the product ensured that the revenue was sufficient to cover both the business's variable and fixed costs. This approach is known as absorption costing, it is only really appropriate for well established, stable businesses with little change to product volumes each year.

## Changes in costs

You should also consider what will happen to your costs over the three years of your forecast. In the early days if you are producing relatively small amounts you will pay a high price for each item of raw material, as your business and volumes grow you will be able to negotiate better prices with your suppliers. These reductions in price-per-unit are known as economies of scale, they can apply to all variable costs – e.g. a large delivery van that is full to the brim will cost less per unit to run than a small one.

Experience – in the same way, as you become more practiced at producing your product you should also experience economies of scale over your internal efficiency – basically you'll get better at producing your product.

Although these factors are very real you should be cautious about including their impact in your forecast. Firstly it is difficult to forecast the impact precisely, and secondly they rely on increasing sales volumes – i.e. there is a double benefit to your profitability from these volume increases. Fundamentally you need to be careful about justifying your business idea on aggressive growth forecasts which may not happen.

## Start-up and capital costs

The final category of costs is one off start-up costs. These contain all the items you'll need to invest in to get your business up and running – for example a new business baking cakes buying an oven. It may include machinery you'll need for production, a lease premium on new premises, computer equipment, the cost of setting up a website, the cost of a delivery van, publicity, legal/tax/accountants' advisory fees, registration fees and so on.

As some of these items will be used over a number of years it would be unfair to "charge" them to your first month's profit. That would result in the first month showing a huge loss and every subsequent month being somewhat flattered. We therefore spread the cost over the period that we'll use the items. For example if the cake maker's oven cost £240 and he thought it would last 2 years, then each month he needs to recognise a £10 cost – almost as if his cake making business is renting the oven. This spreading of costs is called depreciation which you may have heard of.

Again you need to think as widely as possible to ensure you've captured all the costs you'll need to set up your business, every time you look at a business think what it took to get there.

### Template

The accounting treatment of these costs can be a complex subject which is beyond the scope of this module. However there is a simple distinction between one-off costs which should simply be recognised when you spend the money and items that are capital in nature that can be spread or depreciated over a period. An easy way to think of this is to consider whether the item has a second hand value in the 2nd or 3rd month – the cake maker's oven would do, whereas an amount you spent on legal advice would not. The oven is therefore a capital costs and can therefore be depreciated.

The tab **StartUp** in the spreadsheet enables you to include these costs in your forecast. There is a long list of potential items and space for you to describe the amounts and collect the cost. You will see in the example below that there is a column called "life (yrs)". If the item will have use over a number of years and will have a second-hand value you should key in the life in this column. You will then see that the cost is spread over the forthcoming months. If you leave the life as zero all the cost will be charged in the first month.

| Company name: ABC Trading | | | | | | |
|---|---|---|---|---|---|---|
| Start Up Costs | | | | | | |
| | | | | Year 1 | | |
| One-off costs | Description | Amount | Life (yrs) | Mth 1 | Mth 2 | Mth 3 |
| Machinery 1 | Oven | £300 | 3 | £9 | £9 | £9 |
| Machinery 1 | CAD machine | £1,000 | 0 | £1,000 | £0 | £0 |
| Machinery 1 | | | 0 | £0 | £0 | £0 |
| Machinery 1 | | | 0 | £0 | £0 | £0 |
| Machinery 1 | | | 0 | £0 | £0 | £0 |
| Property 1 | Lease premium | | 5 | £83 | £83 | £83 |
| Property 2 | | | 0 | £0 | £0 | £0 |

## Costs – other considerations

### Own costs

At the start of your business it is tempting to simply "add on" your business idea to your current personal circumstances, i.e. to assume that you'll be able to use your current resources (such as your car or mobile phone) to run your business. This is an entirely reasonable approach in the first few months, and there are many examples of successful businesses set up on the kitchen table.

However you should aim to introduce these costs into your forecast as you go through the three years, otherwise you will never get a clear picture of whether your business is making a real profit. In addition if you identify these costs you can set them against your profit and therefore reduce the business's tax bill.

### What not to include

At this early stage you're just trying to get a sense of whether your business is viable. So there are a number of items that you can safely ignore in your forecast. These are very real and important items, often with complex rules and regulations, but for now you just need to be aware of them and the reasons why you can ignore them.

### Taxation

Taxation (or tax) is a complex subject. There are many different rules which are very specific to your business and depend on:

- the structure of your business – whether it's a limited company or sole trader. In turn this impacts whether you'll be paying corporation tax or income tax;
- the area of business you are in – farming for instance has very specific tax treatments;
- how you are paying yourself for time spent on your business; and
- what type of start-up costs you've incurred?

However in the early period if you are not making much profit you shouldn't be paying much (if any) tax. It is therefore reasonable in your forecast to ignore tax while you are assessing the viability of your business. If your forecast shows you making a profit – this is good news and you should therefore be happy that this means you'll be paying tax. If you're not making a profit you need to worry more about addressing your profits rather than worrying about the tax!

The rules relating to the tax treatment of your business is probably the key area where you should take advice from a local accountant. It is worth noting however the tax man is actually helpful – he wants you to follow the right rules and is generally happy to explain them to you. Tax in the UK is administered by HM Revenue and Customs. The links to the website are shown below:

www.gov.uk/business-tax/corporation-tax / www.gov.uk/set-up-sole-trader

## VAT (value added tax)

Again the rules relating to VAT are complex and very specific to the kind of business you are involved in. For instance there was a famous case in 1991 that went all the way to the High Court over whether VAT should be charged on Jaffa Cakes as a biscuit or cake as the rules are different!

In general businesses pay VAT on the things they buy (input VAT) and charge customers VAT on the things they sell (output VAT), both at 20%. The difference between these two amounts of VAT is then paid to or reclaimed from HMRC. The impact on your business will only be the net amount, i.e. the difference between inputs and outputs so will not be an enormous amount. Also until you make sales of more than a certain amount you do not need to add VAT to your sales. At February 2015 this threshold is £81,000 pa. (the limit increases each year and can currently be found at: www.gov.uk/vat-registration-thresholds)

The safest approach therefore is to include VAT in your costs, i.e. you will pay this, but for the purpose of your forecast to not include VAT in your sales. This will give you a prudent view of your likely profitability.

As with taxation, once your business is up and running you should take advice from an accountant who will understand how VAT applies to your specific business and will help you set up a process for accounting for it.

## Your salary

Remember that if you are working full time on setting up and running your business you won't have a salary. Again at this stage you should ignore your salary and focus on whether the underlying business will be profitable. If the business is entirely yours, then any profit represents the return to you. You need to consider (i) whether you can survive the early period when the business will either be loss making or making such a small profit that it can't afford to pay you any salary and (ii) whether the profits that the business will make towards the end of your period will be sufficient for you.

Finally, it is again worth making the point that there are complex legal and tax issues relating to how you pay yourself and you should take an accountant's advice. They will consider whether you are a sole trader or limited company, the level or profits you are making, whether it is beneficial to pay yourself a salary or dividends or a mix of the two.

### Interest

We will consider the financing of your business in more detail in the second module. At this stage however you still need to consider any financial obligations you have to the people that have financed your business. If for instance you anticipate borrowing money from a bank then you will need to include both the interest payments and also the repayment of capital in your forecast. Likewise if friends or family have agreed to lend you money for a period then you need to ensure you include the repayment of that in your costs.

## Cash flow

A significant factor in understanding a business's accounts is appreciating that **profit does not necessarily equal cash**. In fact many profitable businesses go bankrupt because they run out of cash.

We have mentioned an example of this earlier with the cake maker's oven – he had to pay for it today (in cash – which will appear in his cash flow) but in his profit and loss account we spread that cost over two years as that is a fair allocation of how the business is 'using' the asset. Likewise if you make a sale to a customer you record that sale today in your profit and loss account. However he may not pay you for a couple of months and therefore the cash does not appear in your bank until later. In both of these cases therefore the profitability of the business looks better than the cash flow.

Unfortunately as a new business you are not in a strong position in relation to cash:

- you are unlikely to have significant cash reserves to fall back on;
- as a new customer, with no track record your suppliers perceive you as risky and are likely to demand payment either up front or only offer with a short credit period;
- as a new supplier – you will have little leverage over your customers and therefore may have to offer extended credit periods. If those customers pay late you'll have little bargaining power to encourage them to pay up!;
- as a growing business you will continue to absorb cash. This is known as the working capital cycle. Using a simple example: if you receive orders for more of your product this month than last month you need to pay (in cash) for the extra raw materials to make those extra products today, you then have to make the product and then wait for the customer to pay you. Every time you increase your sales, you need the cash reserves to finance this cycle.

It's therefore vital that you carefully forecast your cash flows and take a relatively prudent view of your cash position.

## Template

The spreadsheet template has the facility to incorporate profit/cash adjustments in order to produce a cash flow. The key inputs you need to provide relate to your sales and variable costs. You may have noticed pink cells – these allow you to key in a delay in months for your customers (i.e. on the sales tab if you type in "2" the cash flow will recognize cash receipts two months after you have sold the item). If you leave it blank, or zero you'll receive the cash at the same time (please note that there is a maximum delay in the template of 6 months for both sales and costs).

| Company name: ABC Trading | | | |
|---|---|---|---|
| **Sales** | | | |
| | **Credit** | | **Year 1** |
| | **Mth** | | **Mth 1** |
| Product 1 | 2 | Volume | 12 |
| | | Price | £45.00 |
| | | Total | £540 |
| | | | |
| Product 2 | 0 | Volume | 50 |
| | | Price | £9.99 |
| | | Total | £500 |

The **variable cost** tab also has a pink cell alongside the costs of each product enabling you to delay the payment to suppliers. Note that this is an average for all the components of its cost card.

# Your completed forecast

You should now have input all the elements into your first forecast. If you look at the tab **PandL** you'll see a summary profit and loss account for the three years and tab **CashFlow** will show you your completed cash flow. Note that standard accounting practice is to show negative items such as costs in brackets, and positive items without brackets.

# Profit and loss account

This statement will give you a good sense of whether your business is fundamentally viable. In particular if you look at the second and third years you are basically looking at the trading performance of the business once it is established.

| Company name: ABC Trading | | | | |
|---|---|---|---|---|
| **Profit and loss account** | | | | |
| | **Year 1** | | | |
| **All amounts in £** | **Mth 1** | **Mth 2** | **Mth 3** | **Mth 4** |
| Sales | 1,040 | 1,484 | 1,474 | 1,764 |
| Variable costs | (775) | (2,898) | (1,087) | (1,320) |
| Contribution | 264 | (1,414) | 387 | 444 |
| Fixed costs | (176) | (176) | (176) | (176) |
| Trading profit | 88 | (1,590) | 211 | 267 |
| Start up costs | (1,093) | (93) | (93) | (93) |
| Net profit | (1,004) | (1,682) | 119 | 175 |

You will notice that there is a subtotal in the profit and loss account called contribution. This is an accounting term which takes sales less variable costs, this amount then "contributes" to the fixed costs. If you double your sales volumes, then all else being equal the contribution should double and fixed costs should stay the same. Looking at this line should give you a good feel for the impact of growing your business over later years.

There is another tab called **Product** which shows the contribution calculated for each of your products. Again this gives you a good feel for the trading performance of each of your product lines.

| Company name: ABC Trading | | | | |
|---|---|---|---|---|
| **Contribution by product** | | | | |
| | | **Year 1** | | |
| **All amounts in £** | | **Mth 1** | **Mth 2** | **Mth 3** |
| Product 1 | Sales | 540 | 585 | 675 |
| | Var Costs | (275) | (298) | (327) |
| | Contribution | 265 | 287 | 348 |
| Product 2 | Sales | 500 | 599 | 799 |
| | Var Costs | (500) | (600) | (760) |
| | Contribution | (1) | (1) | 39 |
| Product 3 | Sales | | 300 | |
| | Var Costs | | (2,000) | |
| | Contribution | | (1,700) | |
| Product 4 | Sales | | | |
| | Var Costs | | | |
| | Contribution | | | |

Remember that you have not included in this forecast your own costs (your salary) – if you are going to devote yourself full time to this business it needs to make enough money for you to take out. In addition as the business grows it will need to reinvest in itself – e.g. moving to bigger premises, buying new machines, advertising costs as it moves into new markets, etc. Your business needs to be generating sufficient profits to do this.

## Cash flow

Perhaps more important over these early years is the **cash flow**. This tab simply picks up all of the cash receipts from sales and cash payments for your costs and totals them for each month. It adjusts for the credit period offered to customers and by suppliers and the timing of fixed and start up costs.

| Company name: ABC Trading | | | | | |
|---|---|---|---|---|---|
| Cash flow | | | | | |
| | | Year 1 | | | |
| All amounts in £ | | Mth 1 | Mth 2 | Mth 3 | Mth 4 |
| Receipts | Product 1 | | | 540 | 585 |
| | Product 2 | | | | 500 |
| | Product 3 | | | | 300 |
| | Product 4 | | | | |
| | Product 5 | | | | |
| Payments | | | | | |
| Variable costs | | | | | |
| | Product 1 | | (275) | (298) | (327) |
| | Product 2 | | (500) | (600) | (760) |
| | Product 3 | | | (2,000) | |
| | Product 4 | | | | |
| | Product 5 | | | | |
| Fixed costs | | (384) | (64) | (84) | (334) |
| Start up costs | | (6,300) | | | |
| Total cash in/(out) flow | | (6,684) | (839) | (2,442) | (36) |

You will see that the final lines on this spreadsheet show the cumulative cash position. Most new businesses have very high cash outgoings in the early months as they get themselves established and then later, as long as the business is trading well, they start to generate cash.

You should therefore look for the months with the maximum negative cash position – you will need to finance this shortfall somehow. For most small businesses this finance is likely to come from your own funds, i.e. savings, perhaps a redundancy payment or amounts you can borrow. You will notice that the opening cash position is zero, if you are able to invest any money into your business then this amount can be entered into cell D30 and the spreadsheet will recalculate the net cash position.

| | Mth 1 | Mth 2 | Mth 3 | Mth 4 | Mth 5 |
|---|---|---|---|---|---|
| Cash brought forward | 0 | (6,684) | (7,523) | (9,966) | (10,002) |
| Add cash flow for month | (6,684) | (839) | (2,442) | (36) | 20 |
| Closing cash | (6,684) | (7,523) | (9,966) | (10,002) | (9,982) |
| | | | | maximum negative cash | |

## Uncertainty

### Prudence

As we've already mentioned forecasting the future is difficult.  No matter how well researched you are it is inevitable that your sales and costs will turn out to be different to your forecasts. The environment in which your business will operate is a source of both opportunities and threats from changes in the political, economic, social, technological, ecological and legal factors.

New businesses rely on enthusiasm and optimism and of course you wouldn't be considering your business if you weren't hoping for success. However you should temper this enthusiasm with a healthy dose of prudence. It's inevitable that certain things won't go as well as you anticipate.

### Scenarios

It is useful to consider a number of different scenarios, for instance if you've assumed that volumes increase at say 25% pa, you could construct another scenario with growth of only 10% pa. or with a lower sales price. Remember to adjust any variable costs that will also be impacted and save your spreadsheets as different scenarios.

These different scenarios will help you to identify the factors that your business is most sensitive to; you should then investigate these items further to validate your original assumptions.

You could draw up three alternative scenarios with a best case/worst case/most likely set of assumptions. These would give you the range of outcomes. The simple process of considering these alternative scenarios will help you to think through what you would do if these things happened.

### Break-even point

One final scenario you should consider is to return to the profit and loss calculation and look at the contribution line. You could calculate how much lower your volumes could be before you make a zero profit, i.e. your contribution is equal to all the fixed costs below. The volume at this point is called the break-even point, and is a very useful indicator – if you can't sell more than this – you will never make a profit.

# Legal requirements and practical issues

When setting up a new business there are a number of legal requirements and practical issues you need to comply with. As discussed earlier, this toolkit cannot cover every precise requirement for every potential business; the following is a generic checklist of issues you should consider.

With any business venture there are many rules and regulations you can either fall foul of or take advantage of. If your business is involved in food preparation or employs staff the number of rules will increase substantially so it is worth taking professional advice over your precise circumstances.

## The Legal Structure of Your Business

This introduction module has assumed that your business is set up as a "sole trader". Essentially this means that it operates as an extension of you and the business's profit and tax are treated as your own income and tax. However your business could be established as either a Partnership or a Limited Liability company.

The benefits of setting your business up as a Limited Company will be considered in the second module, for now we'll assume you are a sole trader. This structure requires no formal registration other than informing HM Revenue and Customs (HMRC) that you have started trading. You should inform them of this as soon as possible, but no later than the 5th October of your second business tax year. Failure to do so may carry penalties.

Registration can be completed at www.gov.uk/set-up-sole-trader/overview

As the company operates as an extension of your own activities you will be responsible for completing a tax return, for paying over income tax and also National Insurance contributions. The above link provides detailed information on the processes and requirements when setting up as a sole trader, such as rules on what company name you can use.

## Accounting software and record keeping

Accounting is fundamentally about telling a story based on financial transactions. It is therefore vitally important that you are scrupulous about record keeping. Right from the beginning set up files (both electronic and hard copy) for expenses and sales.

In addition you should consider investing in Accounting Software to help you capture each transaction. This doesn't have to be expensive – in fact there are a number of on-line accounts packages that are free.

If you use an accountant for advice and for helping you prepare your accounts and tax returns, they will have come across a number of accounts packages and will be able to give you the benefit of their experience.

## Find an accountant

Accounting is fundamentally a straightforward process (it is after all just a slightly more involved version of what you do with your own wages and expenses). However there are a great many rules and regulations, especially in relation to taxation, that you can either fall foul of or take advantage of. It therefore makes sense to find an accountant that knows about your proposed industry in your area so they can help you maximise any benefits and stop you falling into a tax or legal hole that costs you money. If an accountant can't save you more money than the cost of employing them – it could be argued they are not doing their job!

As well as tax advice, a good accountant should be able to advise you on wider issues, such as setting up your business, grants and other methods of financing your business, business structures, methods of paying yourself, and broader business issues.

If you use your accountant to prepare your annual accounts and tax return then this will let you get on with running your business, rather than worrying about the detail of these items.

## Bank account

It is important that you set up a separate bank account for your business as soon as possible. This will enable you to keep all of your expenses and revenue separate from your personal items which will in turn make it easy for you to monitor the progress of your business and compare it to your forecast. It will also make it easier for you to identify and justify expenses to the tax authorities and ensure you are offsetting those items against your taxable profit.

Note that banks in general do not offer free banking to businesses, you should expect there to be a small charge for each transaction such as each cheque you write.

## Insurance

You should ensure you have sufficient insurance for your business such as insurance for public liability (if your business causes harm to a member of the public), employer's liability insurance (covering your employees) and insurance for your business assets.

## VAT

We briefly mentioned VAT earlier in the 'finance and your first forecast' part of this module, it is worth repeating however that if your business's VATable sales (total sales on which VAT would be charged) reach a certain threshold [currently £81,000 for the tax year 2014-2015], you are legally obliged to register for VAT, to add VAT to your sales invoices and to pay over any net VAT to HMRC. Failure to do so carries significant financial penalties.

As with much tax legislation the precise rules relating to VAT can be complex, many foods for instance are zero rated. The rates are listed on the government's VAT website: www.gov.uk/rates-of-vat-on-different-goods-and-services.

Therefore you should carefully review the VAT legislation and take professional advice where appropriate. For instance an accountant may advise you to register for VAT even if your sales have not reached the threshold. This is often the case in the food industry as registering enables you to reclaim VAT that you have paid on your inputs (supplies) which could reduce some of your business's costs.

## Licences

Certain business activities must be licensed in order to trade. This applies to industries such as food manufacturing, public houses and hospitality. When setting up a food business in Wales you must contact the local council to register your business – food operations include:

- selling food;
- cooking food;
- storing or handling food;
- preparing food;
- distributing food.

You must register every premises where you carry out food operations, including your home, and mobile or temporary premises such as stalls and vans.

If you make, prepare or handle food that comes from animals, for example meat or dairy products, your premises may need to be approved by the council before you can undertake the activity. In some instances you don't need to be inspected or approved such as if you sell direct to the public or retailers like caterers, pubs and restaurants, as long as:

- food is less than 25% of your trade;
- you don't handle any wild game meat products;
- you don't sell food outside the county your business is registered in.

You must still follow the rules for controlling the temperature and storage of any food you transport. Failure to register and secure approved status could be a criminal offence carrying penalties.

You should contact your local council, or check their website, to find out how to apply for a licence and how and where you need to display your approved status.

## Food safety management systems and HACCP

Under UK law all UK Food and Drink businesses must put in place a food safety management system based on HACCP principles.

HACCP (Hazard Analysis and Critical Control Point) is a system that helps food business operators look at how they handle food and introduces procedures to make sure the food produced is safe to eat. HACCP is based on principles established by NASA when preparing food for astronauts!

There is an online tool based on HACCP principles that the Food Standards Agency has set up particularly for small food businesses. It can be found at: www.food.gov.uk/business-industry/manufacturers/myhaccp

Increasingly smaller food and drink manufacturers are looking to achieve a recognised industry accreditation such as SALSA – Safe and Local Supplier Approval. Accreditation will demonstrate your proficiency to trade customers and give you assurance that you are running your business in a professional manner. More information on SALSA can be found at: www.salsafood.co.uk/

Larger food and drink producers or companies wanting to supply own label/retailer branded products will need to achieve a much more onerous accreditation in the form of BRC – British Retail Consortium www.brcglobalstandards.com/

In Wales support is available for food and drink companies through the Food Innovation Centres such as Coleg Menai, Horeb and Cardiff Metropolitan University.

## The Food Standard – Technical Hierarchy

A good place to start would be to understand the Food Safety Standard as it exists in the UK.

The BRC Food Safety Standard can be used by any food processing operation where open food is handled, processed or packed. This could be from primary products such as fresh produce pack houses and slaughterhouses through to processed foods, canneries and ready to eat products. The BRC Food Safety Standard helps to establish good manufacturing practices so you'll produce safe, legal products that meet the quality levels expected by your customers.

The Standard is divided into seven sections:

**1. Senior Management Commitment and Continual Improvement**
For any food safety system to be effective it's essential the senior management team is fully committed to its application and continued development. Evidence must be demonstrable that this commitment is "live".

**2. The Food Safety Plan (HACCP)**
The basis for the Food Safety System is an effective HACCP (Hazard Analysis and Critical Control Point) program based on the requirements of the internationally recognised Codex Alimentarius system. (The Codex Alimentarius is a collection of internationally recognized standards, codes of practice, guidelines and other recommendations relating to foods, food production and food safety.)

**3. Food Safety and Quality Management System**
Sets out requirements for the management of food safety and quality, building upon the principles of ISO 9000. This includes requirements for product specifications, supplier approval, traceability, and the management of incidents and product recalls.

**4. Site Standards**
Sets out expectations for the production environment including the layout and maintenance of the buildings and equipment, cleaning, pest control, waste management and foreign body controls.

**5. Product Control**
Includes the requirements for product design and development stage including allergen management, product and ingredient provenance, product inspection and testing as well as packaging compliance (date codes, descriptions and warnings).

**6. Process Control**
Includes the establishment and maintenance of safe process controls, weight/volume control and equipment calibration, and ensures the documented HACCP plan is put into practice.

**7. Personnel**
Sets out the standards needed for staff training, protective clothing and personal hygiene.

The following actions are recommended when thinking about your food standards:

- Do your research to determine what level and type of certification and compliance your business needs to produce safe food products for your customers.
- Approach the relevant industry body and register your business.
- Consider what external and internal technical resource you will need to design and implement your various quality and other control systems and activate these.
- Design an overall business policy and publish this internally and communicate this with your customers.
- Create a project/programme for installation and implement.
- Remember to accommodate for ongoing technical control, audits and compliance measures in your business budget.

## Health and safety

If you employ anybody, you have a legal duty to protect the health and safety of your employees and other people who may be affected by what you do. Even if you're self-employed you still need to take care of your own health and safety and that of people affected by your work. It is therefore a legal requirement that every employer and self-employed person makes an assessment of the health and safety risks arising out of their work.

However only businesses with five employees or more will need to create a written health and safety policy after identifying risks. A written health and safety policy describes how you'll manage and prevent risks, outlining to your staff and the wider world how you'll commit to health and safety law.

Although this may sound daunting it is largely common sense and would include taking steps such as having locking mechanisms on dangerous machinery or "caution HOT" signs on ovens.

Health and safety in UK is administered and enforced in UK by the Health and Safety Executive. They have useful guidance including a toolbox and templates for small businesses at the following link: www.hse.gov.uk/leadership/smallbusinesses.htm

## Trademarks, packaging and barcodes

We will consider factors such as branding and packing in much more detail in the marketing section, the 3rd module. However even at the early stages of your business you should consider the name of your product and how it is packaged.

### Trademarks and packaging

If you intend on branding your products as opposed to producing them for someone else to brand as their own, you will have to ensure that the name, packaging and features of your product are unique and do not infringe any already registered trademarks. Over the years Apple Computer paid Apple Corps (the owners of the Beatles records) over $50m for resolving legal disputes over infringing their name!

Simply using a search engine such as google to search for a name will be a good start and help you identify whether anybody else is using that name. As we have already mentioned, Companies House will have records of all limited companies with a particular name, so this can be another good place to start. It is worth using specialist advisors before investing significant sums on marketing or packaging.

### Barcodes

Any product that is to be sold through a retailer will need to have a barcode so it can be scanned at the point of sale. In UK these are issued and administered by www.gs1uk.org. GS1uk also deal with the more modern QR codes and also are part of the worldwide consortium dealing with RFID tagging.