FINANCIAL FUNDAMENTALS

Basic Financial Terms and Concepts

Below is a discussion about basic financial terms and concepts to aid in understanding, creating and analyzing financial statements.

There are certain questions all organisation owners would like answered. We are looking to answer these questions with the financial information that we gather. Organisations that practice sound financial management and record-keeping will easily be able to answer all of these questions.

There are a number of key accounting terms:

We'll now discuss the basic financial terms and concepts that will help you to answer the above questions. It will also help you understand financial statements, draw them up and make decisions when analysing them.

1. **Income**
   Income represents all revenues earned by the organisation. This may be revenue generated from sales of products, services rendered or property leased out. When it comes to the Vision Centres, the sole revenue will be from the sales of spectacles.

2. **Expenditure**
   Expenditure represents the money used to pay suppliers, make payments for operating expenditure such as rent, transport or for services received. Consumables, such a tints, which are purchased for use in the Dispensing workshop, are considered an expense.

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3. **Assets**

Assets take many forms and include land and buildings, equipment and other resources owned by the organisation. There are two basic types of assets:

a. Fixed Assets
These assets are not in a very liquid form and cannot easily be converted into cash in the short term. There are two types of fixed assets which are moveable and immovable.

i. Moveable assets are items such as vehicles, equipment and furniture.

ii. Immoveable assets include land and buildings and fixed equipment.

b. Current Assets
These are assets belonging to the organisation but are constantly changing in value in the short term and are very liquid. Examples of current assets are Bank and Debtors accounts.

4. **Liabilities**

Liabilities are any property, resources or monies owing to other individuals or organisations, which are called creditors.

5. **Owner's Equity**
Owner's equity is the money and property invested by the owners of the organisation.

Further financial terms

1. **Debtors**
Debtors are individuals or organisations who owe the organisation money. In a Vision Centre these may be patients who have outstanding payments for spectacles, which they may have purchased.

2. **Creditors**
Creditors are individuals or organisations to whom the organisation owes money. In a Vision Centre a creditor may be a lens supplier with whom it may have a 30 or 60 day account.

3. **Cost Price**
The cost price is the price paid to the supplier for goods purchased. The total cost price includes this price plus the cost of getting the goods from the supplier to your business.

Example
If you purchased a pair of spectacles from a supplier at $1.00 and the cost of transporting it from the supplier to your business is $0.50, then the total cost price of that pair of spectacles is $1.50. There may be other costs beside transport costs that may be included in calculating the total cost price, such as clearing costs and insurance.

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4. **Markup**
   This is the amount added to the total cost price to determine the price at which you will sell the item to the customer or patient e.g. if the total cost price of a pair of spectacles is $1.50 and you sell it to the customer or patient for $2.00, then your markup is $0.50. A markup is generally expressed as a percentage and calculated as follows:

   ($0.50 / $1.50) x 100 = 33.3%

5. **Selling Price**
   This represents the price at which goods are sold to the customer or patient. It is the total cost price plus the markup.

6. **Total Sales**
   This represents the total amount of all the goods sold within a certain period.

   Example
   If 10 spectacles were sold at $2.00 each during December, the total sales amount will be $20.00 i.e. 10 x $2.00.

7. **Gross Profit**
   This equals the totals sales minus the total cost price of all goods sold for a particular period. If the sales amount is greater than the cost of sales, then the business makes a positive Gross Profit.

8. **Net Profit**
   This equals your Gross Profit plus other income that the business may generate minus all operating expenditure incurred by the business for the same period. Other income may be rent earned on premises leased out by the business to another. If the net profit amount is a positive figure then the business is making a profit.

9. **Budget**
   A typical budget for most businesses represents the expected income and expenditure of the business for a period of usually one financial year. It plans out how the funds available will be distributed across all the expenditure for that particular year.

   A budget may also be drawn up for a particular project to capture the expected initial cost outlay.

   In summary a budget may take many forms depending on the circumstances and need and is drawn up to determine the expected expenditure or income of a particular operation or project.

10. **Financial / Fiscal Year**
    A financial year represents a period of 12 months starting at the beginning of any particular month of the year and ending 12 months later. Unlike a calendar year that begins in January and finishes in December, a Financial Year may start at the beginning of June in one year and finish at the end

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of May the following year. The choice of month when a financial year starts depends entirely on the organization in accordance with the local accounting and auditing standards.

Introduction to basic financial calculations

Calculating Total Cost Price

When setting a selling price for a particular product it is important to calculate the total cost price of the product first. This is important so that all the costs involved in getting the product to your premises are included. By doing this one will be able to ensure that the selling price is not set below the total cost of that item which may result in losses to the organisation.

In most cases there are two costs the contribute to the total cost of a product, which are:

- The cost price of the product from the supplier.
- The freight and clearing costs involved in transporting the product from the supplier to your premises.

Example:
A company, New Age Spectacles, purchases 100 spectacles from its supplier at a cost of $2.00 each. The freight and clearing costs involved in bringing the shipment of 100 spectacles to New Age Spectacles warehouse is $50.00.

New Age spectacles want to calculate the total cost of each item.

A - Total number of spectacles ordered = 100
B - Total freight and clearing costs for the shipment = $50.00
C – Cost price of each spectacle = $2.00

Step 1: Calculate the ratio to allocate the freight and clearings costs to each item
1 divided by A i.e. 1/100 = 0.010

Step 2: Use this ratio to calculate the freight and clearing cost for each pair of spectacles.
0.010 time B i.e. $50 x 0.010 = $0.50

Step 3: Calculate the total cost price per spectacle
$0.50 plus C i.e. $0.50 + $2.00 = $2.50

The total cost of each spectacle is therefore $2.50

a. Calculating Selling Price

When calculating the selling price the following may need to be considered:

- The market related selling price of similar products.
- Your target market's (patients) income level. What can they afford?
- What income do you need to generate on a monthly basis to cover all your operating expenditure for that month? How many products do you need to sell to realise this income?

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There may be other numerous factors based on the unique circumstance, which may need to be considered as well.

Once all of the above have been investigated one will need to decide on a markup on the total cost price to set the selling price.

Example
New Age Spectacles has calculated that their total cost price of one pair of spectacles is $2.50. After their investigation they decide to set a markup of 50%. The selling price will therefore be the cost price of $2.50 plus another 50% of $2.50. It is calculated as follows: $2.50 + (150/100) = $3.75

The selling price of one pair of spectacles will be $3.75.

Introduction to financial statements

There are a number of basic financial statements that we will discuss now:

- Balance Sheet
- Income Statement
- Statement of Cash Flows

Together, they present the financial position of a company at a given point in time

Balance Sheet

The balance sheet can be regarded as a "statement of financial position". It shows a snapshot of a company's assets, liabilities and equity at the end of the reporting period. It does not show the flows into and out of the accounts during the period.

- Snapshot of financial holdings and liabilities at the close of organisation on a specified date
- Minimum detail is to report assets and liabilities in two categories: Current and Long-term
- Used to determine the financial strength of the organisation

Income Statement

An income statement is a report that shows how much revenue a company earned over a specific time period (usually for a year or some portion of a year). An income statement also shows the costs and expenses associated with earning that revenue. It is primary source of information about an organisation's profitability.

- It presents the results of operations over a period of time
- It is composed of Revenues, Expenses, and Net Income
- Shows Net Income = Revenue - Expenses
    - Positive Net Income indicates the company generated a profit (net profit)
    - Negative Net Income indicates the company suffered a "net loss"

Cash flow statement

The cash flow statement presents sources and uses of cash by the organisation. Cash flow statements report a company's inflows and outflows of cash. This is important because a company needs to have enough cash on hand to pay its expenses and purchase assets. While an income statement can tell you

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whether a company made a profit, a cash flow statement can tell you whether the company generated cash.

A cash flow statement shows:

- Cash flows from operating activities
- Cash flows from investing activities
- Cash flows from financing activities
    - Net effect of foreign exchange rates
    - Net change in cash balance during the period
    - Non-cash investing and financing activities

Relationship between the reports

Although we have discussed each financial statement separately, they are in fact all related. The changes in assets and liabilities on the balance sheet are also reflected in the revenues and expenses that you see on the income statement, which result in the company's profits or losses. Cash flows provide more information about cash assets listed on a balance sheet and are related to net income shown on the income statement.

No one financial statement tells the complete story. But combined, they provide very powerful information about an organisation.

Using Financial Reports

The value of reports is only gained by the way they are used. Reports should be used as a planning tool. You can use financial reports to:

- Gain insight into your sales
- Income statement (P&L) shows your profitability
- Balance sheet shows assets, liabilities and equity
- Regularly monitor your profitability – and your cash flow

It is essential that every organisation is aware of its financial performance and status. This will firstly help determine whether the organisation is making a profit or a loss. From this exercise you will also be able to adjust the income and expenditure and take action accordingly.

For example, if you noticed that your stationery expenditure was too high and you took steps to save costs, you will be able to review the stationery expenditure after a certain period to determine if your efforts were effective.

A template of a Monthly Income Statement which may be used has been included in the accompanying CD (Refer to CD – Stage 4 – Finance – Income Statement). An Income Statement is basically a statement of all your income and operating expenditure for a particular month. If your income is greater than the operating expenditure, the net result is a Profit. However, if the operating expenditure is greater than the income, the business will make a Net Loss.

Line items for the Operating Expenditure may be added or removed depending on the relevance. To complete this financial statement it is important that a record of all income and expenditure is recorded.

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Further concepts

Finance processes

In order for Finance team to be effective, a set of finance processes need to be developed and documented. Accounts Payable process is to ensure the expenditure is accrued in a timely manner and the creditors are paid according to the credit terms. Accounts Receivable process aims to ensure the debtors are closely monitored and followed up so that the organisation will be able to maintain a sufficient level of working capital at all times. Inventory Management Process is to ensure that a regular stocktake is undertaken to safeguard the assets of the organisation. Other processes could include, but not limited to, Purchase Order Process, Petty Cash Process, Payroll Process, Capital Expenditure Management Process, Travel Policy, Month End Reporting Process, Budget Process and etc.

Accounting System

A computerised accounting system/package would be highly recommended in consultation with the relevant accountant and management to ensure there is an audit trail for auditing purpose. An appropriate chart of accounts should be developed to satisfy the business's needs.

Finance Risk Management

The organisation needs to develop a Risk Management Strategy to minimise the following risks;

- Credit Risk can be minimised through monitoring Aged Accounts Payable and Aged Accounts Receivable on a regular basis.
- Liquidity Risk can be minimised through accurate budgeting with enforcement, weekly and monthly cash forecasting, and monthly reporting to the management.
- Market Risk can be applicable when there are many multi-currency transactions. This can be mitigated, to some extent, by currency hedging and other complex financial products.

Filing and Record Keeping

What is important for any business, irrespective of the systems or practices that are adopted, is a meticulous record of all financial transactions. It is also important that all supporting documents such as receipts and invoices be methodically filed for reference.

Conclusion

What has been discussed so far is by no means a comprehensive guide for operating a Vision Centre. It covers an introduction to basic financials concepts required to operate a Vision Centre. If required a Vision Centre may adopt more complex and comprehensive financial systems and practices. The services of a bookkeeper or accountant may even be used, if required.

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