Basic Financial Management Concepts For SME's

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Agenda

- Common Financial Mistakes That Kill SME's
- Key Financial Management Concepts
  - Financial Information Stakeholders
  - Accounting Information
    - Cash Flow Statement
    - Income Statement(Profit & Loss)
    - Balance Sheet
  - Financial Planning(Budgeting/Forecasting)
  - Business Case- Wazi Furniture
- Highlights of Income Tax and VAT
- Q&A

Common Financial Mistakes That Kill SME's

1. **Not Keeping Financial Records**
2. **Confusing Revenue With Profits**
3. **Spending Money On Things You Don't Need**
4. **Short Term Expectations**
5. **Not Paying Yourself A Salary**

Financial Concepts

- Financial Information Stakeholders
  - Shareholders- Profits, ROI, Dividends
  - Management/Employees-Pay & Benefits
  - Customers
  - Suppliers of goods and services- Honour obligations
  - Government Departments-Taxes, Law, Statistics
  - Communities-Environmental issues
  - Financial Institutions-Loan repayments
- Accounting Information
  - Cash Flow Statement(Cash Book)
  - Income Statement(Profit & Loss)
  - Balance Sheet

FINANCIAL CONCEPTS

- Cash Flow Statement
  - Shows the sources (Cash In) and use of funds(Cash Out).
  - The change is cash position over a period of time
- Income Statement (Profit & Loss)
  - Provides an assessment of whether the revenues generated by the business activity has been profitable during a specific period of time
  - Matches company's accomplishments (sales) with the effort (expenses) spent to generate it during a specific period of time
- Balance Sheet
  - Is a snapshot showing what the company is worth at a set date
  - Is a record of the company's financial structure
  - Shows what the company owns (assets), what the company owes (liabilities) and what belongs to the owners (shareholder's equity)

CASH FLOW STATEMENT

- What are the company's source of cash?
  - Shareholders: buy the company stock in exchange for ownership in the company
  - Lenders: the company borrows cash in the form of loans
  - Vendors(Suppliers): extends credit terms for item purchased
  - Customers: purchase goods and services from the company.
- What can the cash be used for?
  - Paying dividend to Shareholders
  - Paying principal and interest to Lenders
  - Paying operation expenses
  - Investing in fixed assets
- Cash is KING.

Why is a Cash Flow Statement important?

- The Cash Flow Statement can be used to answer the following questions:
  - Does the company have cash?
  - How did the company generate this cash?
  - What is the cash used for?
  - Can the company bears it’s investment?

Profit and Loss statement – Overview

- The Profit and Loss statement (also called Income statement) provides information on the profitability of the company, and on the way the company create it's results or profits.
  - Revenues
    = inflows of cash or other assets that are received in exchange for goods sold or services rendered
  - Costs and expenses
    = outflows of cash or other resources made to purchase supplies or services, to account for use or fixed assets or to pay other obligations such as interest or taxes
- Result = Revenues – Costs and expenses.
  - If result > 0 => Profit
  - If result < 0 => Loss

WHY IS THE PROFIT & LOSS IMPORTANT?

The profit and loss statement can be used to answer the following questions:

- How much money has the company earned (revenues) during the period?
- What did the company spent (expenses) during that period?
- Has the company been profitable during that period?
- How did the company create its result?

Profit and Loss statement – Details

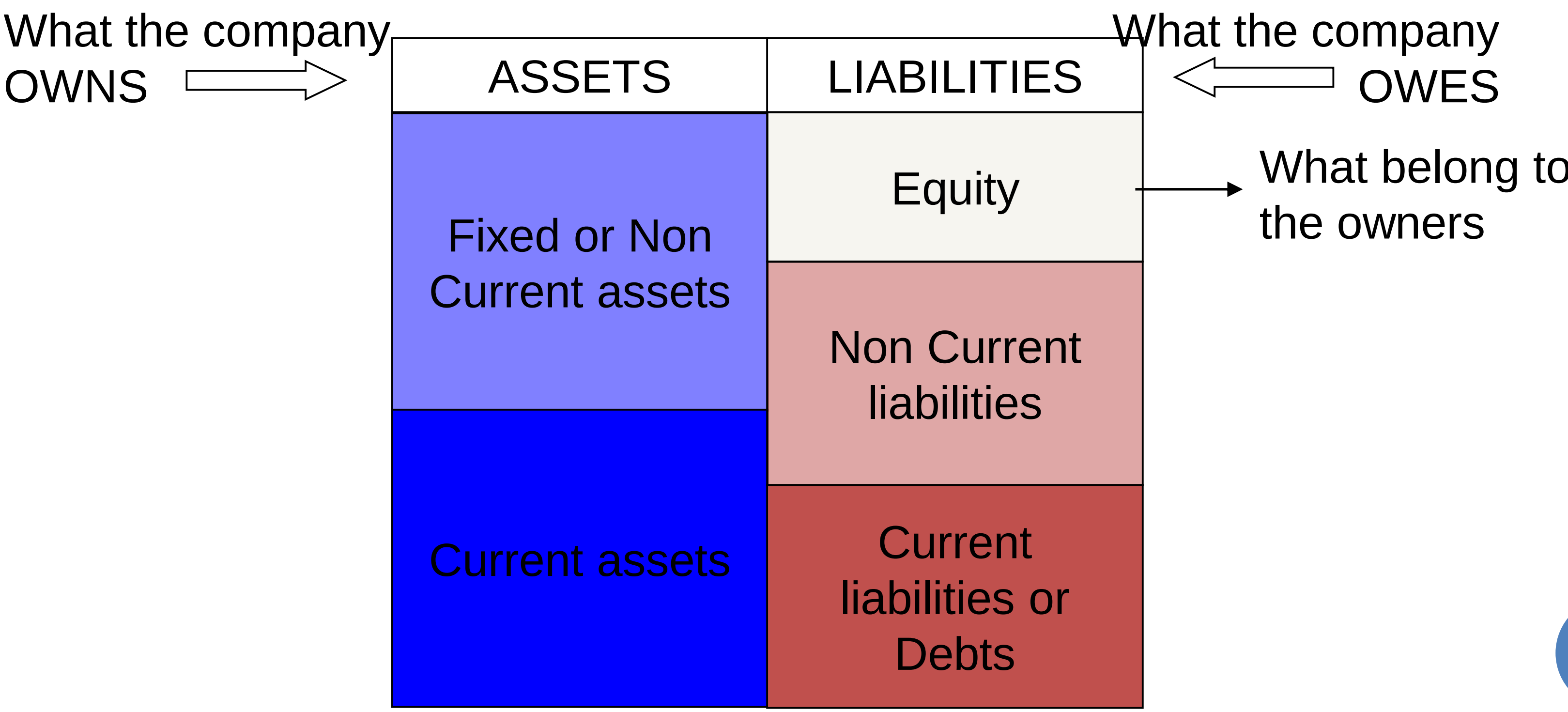
	Revenues	
-	Cost of goods sold or cost of sales	Cost of raw materials and production of sold products, Cost of production of products/services
=	Gross margin	
-	Operating expenses (OPEX)	
=	Operating Income (OP)	
+	Interest revenues	Revenues derived from financial activities sources other than operations, such as interest on temporary investments
-	Interest expenses	Costs associated with the main line of business, such as interest paid to the Bank
=	Income before extraordinary items	
±	Extraordinary items	Infrequent, abnormal gains or losses not related to the operations
-	Provision for taxes	
=	Net Income	

WHY SHOULD THE BALANCE SHEET BE IMPORTANT TO YOU?

- The balance sheet can be used to answer the following questions:
  - Can the company meets its financial obligations?
  - How much money has already been invested in that company?
  - Is the company overly indebted?
  - What kind of assets has the company purchased with its funds?

Balance sheet – Overview

- The Balance sheet is a snapshot of what the company is worth at a set date. It shows:



Balance sheet - Overview

<u>Assets</u>

- Elements that have an economic value for the Company
- Resources available for use by the business
- Utilization of the means/funds the Co. attracted

ASSETS	LIABILITIES
Fixed or Non Current Assets	Equity
	Non Current Liabilities
Current Assets	Current Liabilities or Debts

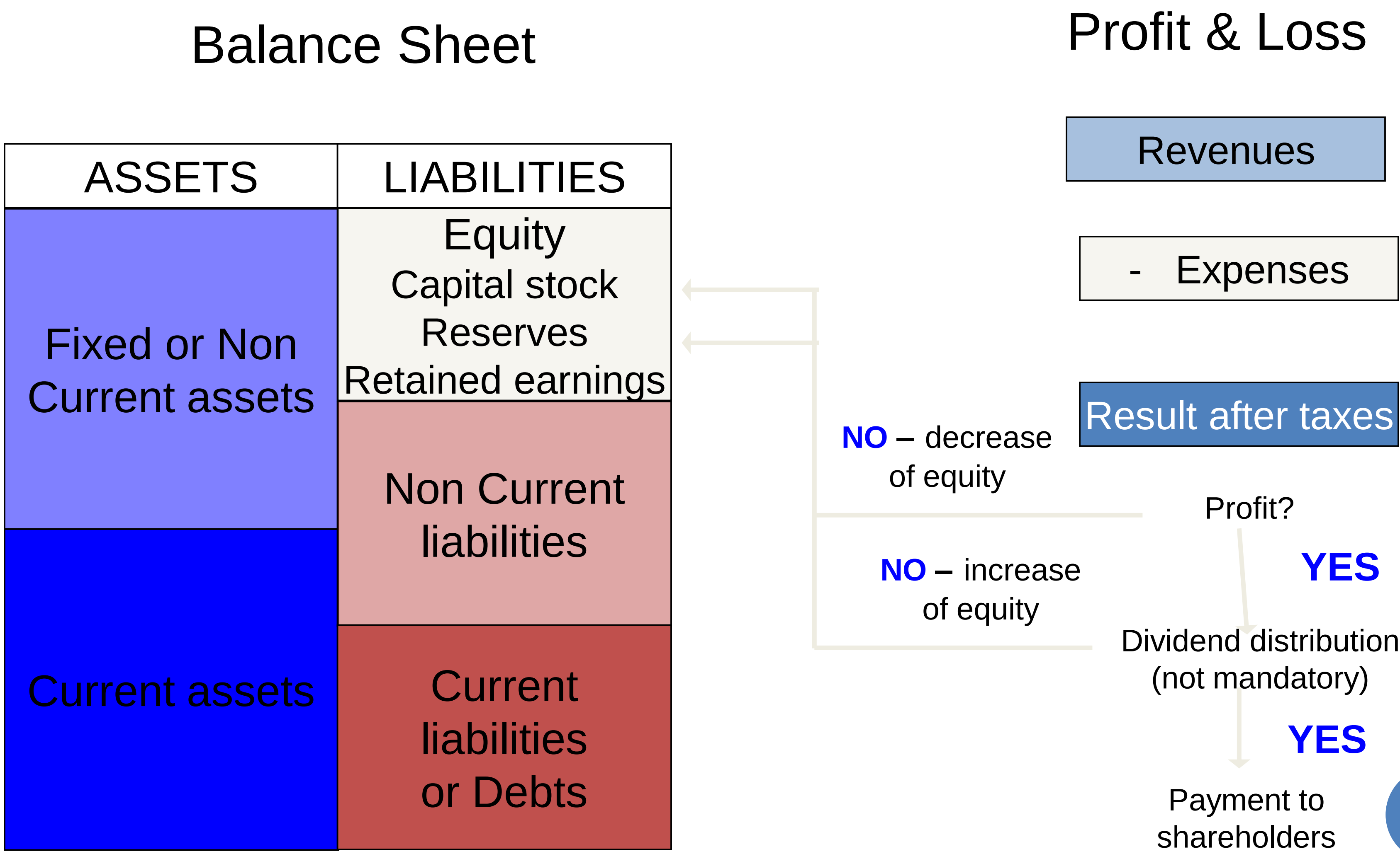
Total ASSETS = Total LIABILITIES

You can not use funds without attracting them!!

<u>Liabilities</u>

- Firm's debt
- Source of Company funding

LINK BETWEEN BALANCE SHEET AND PROFIT & LOSS



Summary of main Financial statements

	Balance Sheet	Income Statement	Cash Flow Statement
	Assets | Liabilities + Equity	Revenues - Expenses Net Income	Beginning Cash balance ± Operating cash flow ± Investing cash flow ± Financing cash flow Ending cash balance
Shows:	Resources available for use and claims of various parties against them.	Results from operation of business	Sources and uses of funds
Time perspective	Snapshot at a point in time	Flows over a period of time	Flows over a period of time
Importance:	High	High	High
	The Effort	**The Return**	

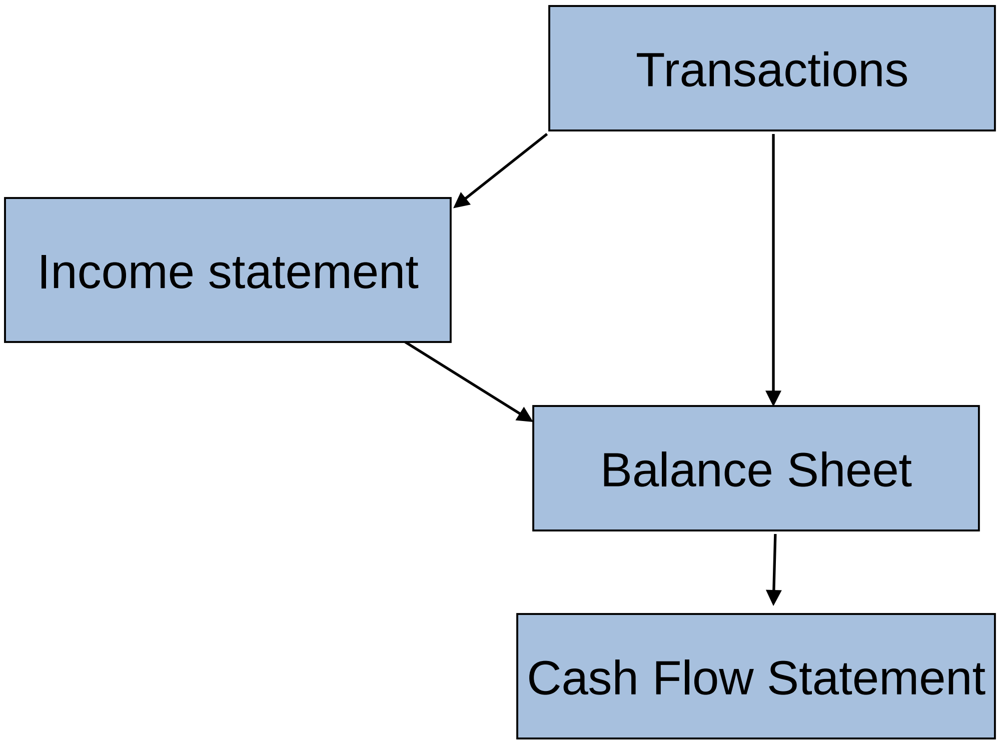
Is the return worth the effort?

Cash is king

... THAT ARE CLOSELY LINKED

Some transactions affect the balance Sheet

- DIRECTLY
  E.g. capital expenditures or payments of bills by customers
- INDIRECTLY via the Income Statement
  E.g. sale of a Product.



All Financial statements are needed to understand the Financial performance of a company.

FINANCIAL PLANNING

- When you run a business, two things are very important:
  - That you do not run out of Cash-Cash is King!!
  - That your business makes a Profit
- Financial Planning involves budgeting or forecasting for both Profit and Cash flow.
  - You should follow up the Sales and Costs as well as your cash flow closely to make sure that everything is going on as planned, if anything goes wrong, corrective action should be taken immediately.
- Follow these steps to plan and monitor the financial situation of your business:
  - Make a Sales and Costs Plan-(Shows the Sales , Costs and Profits your business is likely to have each month)
  - Make a Cash Flow Plan
  - Compare Actual records with both plans every month.
  - Take any corrective action on any huge variations from the plans.

Financial Statements-business case

- WAZI FURNITURE- CASE STUDY.doc

Highlights of income tax and VAT

1 INTRODUCTION.

- The Taxation of Income in Kenya is governed by the provisions of Income Tax Act (Cap 470-Laws of Kenya) which has the Principal legislation with schedules and Subsidiary legislations.

2 SCOPE OF TAX.

- Income Tax is a direct tax that is imposed on Income derived from;
  - Business Income
  - Employment income including benefits
  - Rental income
  - Investment incomes- Dividends, interest
  - Pensions, among others

HIGHLIGHTS OF INCOME TAX AND VAT

3 PERSONAL IDENTIFCATION NUMBER(PIN).

- This is a unique computer generated personal identification number given to every person with income chargeable to Income Tax
- The law requires every person with chargeable income to obtain PIN.
- It is obtained from The Domestic Tax Department at no cost to the applicant.
- The law also makes it mandatory to have PIN for certain transactions listed in the Act, such as motor vehicle transfers, clearance of goods with the Customs Services Department ,new installation of water and electricity meters.etc

HIGHLIGHTS OF INCOME TAX AND VAT

4 SELF- ASSESSMENT RETURNS.

- This is a form in which a taxpayer is required to declare his income and compute his tax liability. The Self Assessment Return should be completed and returned to the Domestic Tax Dept of KRA
- **Individual Tax Payers(Employees/Sole-Proprietors and Partnerships);**
  - The Return of income and Accounts for any year of income should be submitted on or before 30th June of the following year. For example the Return of Income and Accounts for 2014 will be due on or before 30th June 2015
- **Corporate Taxpayers e.g. Limited Companies, Trusts, Co-Operatives etc.**
  - On or before the last day of the Sixth Month after the end of the accounting Period.

HIGHLIGHTS OF INCOME TAX AND VAT

5 - METHODS OF COLLECTING INCOME TAX.

I. Pay As You Earn (PAYE)
II. Corporation Tax
III. Installment Tax
IV. Withholding Tax
V. Advance Tax

Highlights of Income Tax and VAT

1.Pay As You Earn (PAYE)

- PAYE is a method of collecting tax at source from individuals in gainful employment
- The employers will deduct tax according to the prevailing rates of tax from their employees salaries or wages on each payday for a month and then remit the tax to the Paymaster General through the laid down procedure on or before the 9th day of the following month.
- The employee thus has no extra liability at the end of the year unless he has income from other sources including other employments.
- The employers guide to PAYE and the monthly PAYE tax tables are available for free from the DTD.

HIGHLIGHTS OF INCOME TAX AND VAT

2.Corporation Tax

- Corporation tax is a form of Income tax that is levied on corporate bodies such as Limited Companies, Trusts and Co-operatives.
- Resident Companies are taxable at the rate of **30%** while Non-Resident Companies are taxable at the rate of **37.5%**

3.Installment Tax

- Installment tax is paid by both individual and corporate taxpayers who have tax payable in any year, except in the case of individuals whose tax liability for a particular year is fully covered under PAYE or whose final tax liability is below Kshs 40,000.

HIGHLIGHTS OF INCOME TAX AND VAT

- The Installments are spread evenly at 25% of the tax due and is payable on or before the 20th day of the 4th,6th,9th and 12th months of the year of income , except for those in the Agricultural sector whose installments are paid at 75% in the 9th month and 25% in the 12th month.

4.Withholding Tax

- Withholding tax is deducted at source from the following sources of income:
  - Interest
  - Dividends
  - Royalties
  - Management of Professional fees (Including consultancy, agency or contractual fees)
  - Commissions
  - Pensions
  - Rent received by non-resident person
- Withholding tax rates vary for each of the above mentioned sources of income depending on whether the recipient is a Resident or Non-Resident.
- The payer of the income mentioned is responsible for deducting and remitting the tax to the Commissioner.

Highlights of Income Tax and VAT

5.Advance Tax

- Advance tax was introduced to specifically bring the owners of Public Service and Commercial Vehicles and Drivers and conductors of PSV's into the tax bracket.
- It's not a final tax but a tax paid in advance before a public service vehicle or a commercial vehicle is licensed at the applicable rates.

The applicable Tax Rates are specified below:- .

- For Vans, Pick-ups, Trucks and Lorries: - Kshs. 1,500/= per ton of load capacity or Ksh.2,400/= whichever is higher.
- For Saloons, Station Wagons, Mini-Buses, Buses and Coachers:- Kshs. 60/= per passenger capacity per month (Ksh. 720/= per passenger per year) or Ksh. 2,400/= per year, whichever is higher.
- For Drivers and Conductors - Ksh. 3,600/= and Ksh. 1,200/= per year respectively (with effect from 1'1 January,2007).

HIGHLIGHTS OF INCOME TAX AND VAT

6.Tax Incentives

The following Tax incentives are offered by the Tax Authorities that entrepreneurs need to take advantage of them where applicable:

- Capital Deductions
  - Wear & Tear Allowances in respect of-tractors, combine harvesters, heavy earth moving machinery @ 37.5%
  - Industrial Building Allowance in respect of capital expenditure on Hotel Buildings and other Industrial Buildings (4% & 2.5%)
  - Farm works Allowance in respect of capital expenditure on a farm (@33.3% per year)
  - Investment Allowance in respect of capital expenditure in the sectors of Hotels ,Manufacturing and shipping-Both on Buildings and Machinery.
- Export Processing Zones(EPZ)
  - 10Years Corporate tax holiday
  - Lower corporation tax rate of 25% for the subsequent 10years
  - 10 years exemption from all withholding tax on dividends and other payments to non-residents.

Highlights of Income Tax and VAT

Tax Incentives Contd..

- Tax Incentives for Individual Taxpayers
  - Personal relief
  - Relief on premiums paid for Life Insurance
  - Relief/deductions of interest paid on mortgages for owner-occupied house
  - Relief/Deductions of funds deposited under a registered Home Ownership Saving Plan (A Maximum of Kshs 48,000 per year)
  - Tax exemption on interest accruing on housing bonds up to a maximum of Kshs 300,000 per year
  - Tax exemption on contributions to a registered pension scheme or provident funds and no charge to tax on the first Kshs 480,000 of a lump sum commuted from a registered pension or provident fund

NB-It is important to note the various offences under the Income Tax Act in order to comply and avoid the penalties which can hamper the smooth running of a business.

HIGHLIGHTS OF VALUE ADDED TAX -VAT

I. Registration and Qualifications to Register for VAT

II. How VAT Works

III. VAT Rates

IV. Zero Rating and Exempt Supply Concepts

V. Accounting for VAT

1) Issuing a Tax Invoice

2) Input Tax deduction

3) Keeping of Records

4) Submission of Returns

HIGHLIGHTS OF VALUE ADDED TAX-(VAT)

- **Registration**
  - If you supply taxable goods and services and you qualify or wish to register for VAT, you should apply for registration.
  - Those who fall under this category include sole proprietors, partnerships, limited liability companies or corporations.
  - If you are a taxable person you should register for VAT. Registration is now conducted online through KRA online services portal; htt.www.kra.go.ke/portal.
  - The Effective Date of Registration (EDR) is indicated against the VAT obligation on the taxpayer's Certificate of registration generated and from this date the taxpayer should start charging VAT on all taxable supplies. Late application for registration is liable to a default penalty of Kenya shillings 20,000/=

Highlights of value added tax-(VAT)

- **Registration**
  - Once you are registered you are required by the VAT Law to display your registration certificate in a clearly visible place within your business premises.
  - If you fail to do so, you will be liable to a default penalty of Kenya shillings 20,000/= and in addition shall be guilty of an offence and liable to a fine not exceeding Kenya shillings 200,000/= or imprisonment for a term not exceeding two years or both.

HIGHLIGHTS OF VALUE ADDED TAX-(VAT)

Who Qualifies for Registration?

- For you to qualify for registration you must attain or expect to attain a taxable turnover of the value of which is Kshs.5,000,000/= or more in a period of twelve months.
- If you are registrable and fail to register, the Commissioner may register you compulsorily and retrogressively from the date you became due for registration and you shall be liable to a default penalty of Kshs.100,000/=.
- The Act provides for voluntary registration where a taxpayer wishes to be registered despite the turnover falling below Kshs.5,000,000/=

HIGHLIGHTS OF VALUE ADDED TAX-(VAT)

How VAT Works

- Once you are registered you will be required to **charge**, **collect** and **account** for VAT on your taxable supplies and remit the tax to the Commissioner of Domestic Taxes.
- As a registered person you are also legally bound to submit online monthly returns (VAT 3's) with details of tax on goods and services charged to your customers (output tax) and tax on goods and services charged by your suppliers (input tax).

Highlights of value added tax-(VAT)

How VAT Works

- Whenever you make a taxable supply, the supply is your output and the tax you charge is your output tax. If you purchase taxable supplies for furtherance of your business the supply is your input and the tax you pay is your input tax.
- You should subtract the input tax attributable to taxable supplies from your output tax and pay the difference to the Commissioner of Domestic Taxes.
- If your input tax is greater than your output tax you should carry forward the difference as a credit to your next VAT return.

Highlights of value added tax-(VAT)

VAT Rates

- There are two tax rates as specified in the schedules to the VAT Act, which are:
  - 16%: This is the general rate of tax and is applicable to most of taxable goods and taxable services.
  - 0%: This applies to certain categories of goods and services, which includes exports, agricultural inputs, pharmaceutical products, educational materials and supplies to privileged persons.

Zero Rating and Exempt Supplies

- The term zero-rating is used in the VAT Law to refer to supplies of goods and services that are subject to tax at the rate of zero per cent.
- Zero-rated supplies are deemed to be taxable supplies.
- If you supply zero-rated supplies, you charge tax to your customers at 0%.
- The output tax is nil but you are allowed to recover any input tax that has been charged by your suppliers, and which goes into making of those supplies.

HIGHLIGHTS OF VALUE ADDED TAX-(VAT)

Exempt Supplies

- Exempt supplies are business transactions on which VAT is not chargeable at either the zero rate or other rates.
- Exempt supplies are not taxable and do not form part of the taxable turnover. Persons who deal exclusively in exempt supplies are not liable to register and cannot claim input tax on these supplies.
- Exempt supplies are divided into: -
  - (a) Exempt goods: -These are goods listed in the 2nd schedule of the VAT Act.
  - (b) Exempt Services: - are listed in the 3rd schedule of the VAT Act. All other services not in the list are deemed to be taxable.

HIGHLIGHTS OF VALUE ADDED TAX-(VAT)

ACCOUNTING FOR VAT

- After charging VAT, you are required to account for it to the Commissioner. The VAT legislation stipulates following ways in which you should account for the tax:

a) Issuing a Tax Invoice

A Tax invoice is the most important instrument of VAT control.

The VAT Law requires you to issue a tax invoice for every supply of taxable goods or taxable services, which must show the amounts of tax charged.

You must therefore furnish the purchaser with a tax invoice at the time of supply.

HIGHLIGHTS OF VALUE ADDED TAX-(VAT)

b) Input Tax Deduction

- As a registered person you are entitled to input tax deductions for VAT paid on inputs which relate directly to your taxable supplies except where the law prohibits.
- The basis of claiming input tax is the possession of a proper tax invoice (ETR generated) showing VAT charged by your suppliers or Customs entries in case of imported goods.
- According to section 11 of the VAT Act you shall not deduct input tax of more than twelve (12) months after the input tax became due and payable.

HIGHLIGHTS OF VALUE ADDED TAX-(VAT)

(C) Keeping Records

- You are required to keep business records and books of accounts and avail them for verification by an authorized revenue officer whenever demanded.
- The records include: -copies of all sale invoices, original purchase invoices, credit and debit notes, customs entries, audited accounts, ledgers, cash books, bank statements, copies of ETR monthly printout pay-in-slips and a summary of VAT Accounts.
- Records must be kept for a minimum period of five (5) years.

HIGHLIGHTS OF VALUE ADDED TAX-(VAT)

d). Submission of Returns

- As a registered person you are required at monthly intervals to submit through an Online VAT3 return the tax charged to your customers.
- The Taxpayer generates an E-slip which is used to physically pay the tax at the KRA appointed Banks. The Taxpayer may however authorize his bank to pay the tax through a direct credit transfer to the Commissioners account at the central Bank of Kenya.
- All NIL and Repayment Returns are also to be submitted Online.
- The due date for submission of returns is on or before 20th of the month succeeding that in which the sales were made.

Q & A

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