

Finance for Non-Financial Managers

Facilitated by David Maxwell



- **Learning the Language**
- **Profitability – what is it and how do our decisions affect it?**
- **Tools to help measure, maintain & improve our profitability**

The Task:

Run a village pub for five rounds in competition with seven other pubs. The winner is the pub achieving the highest level of profitability in the final four rounds.

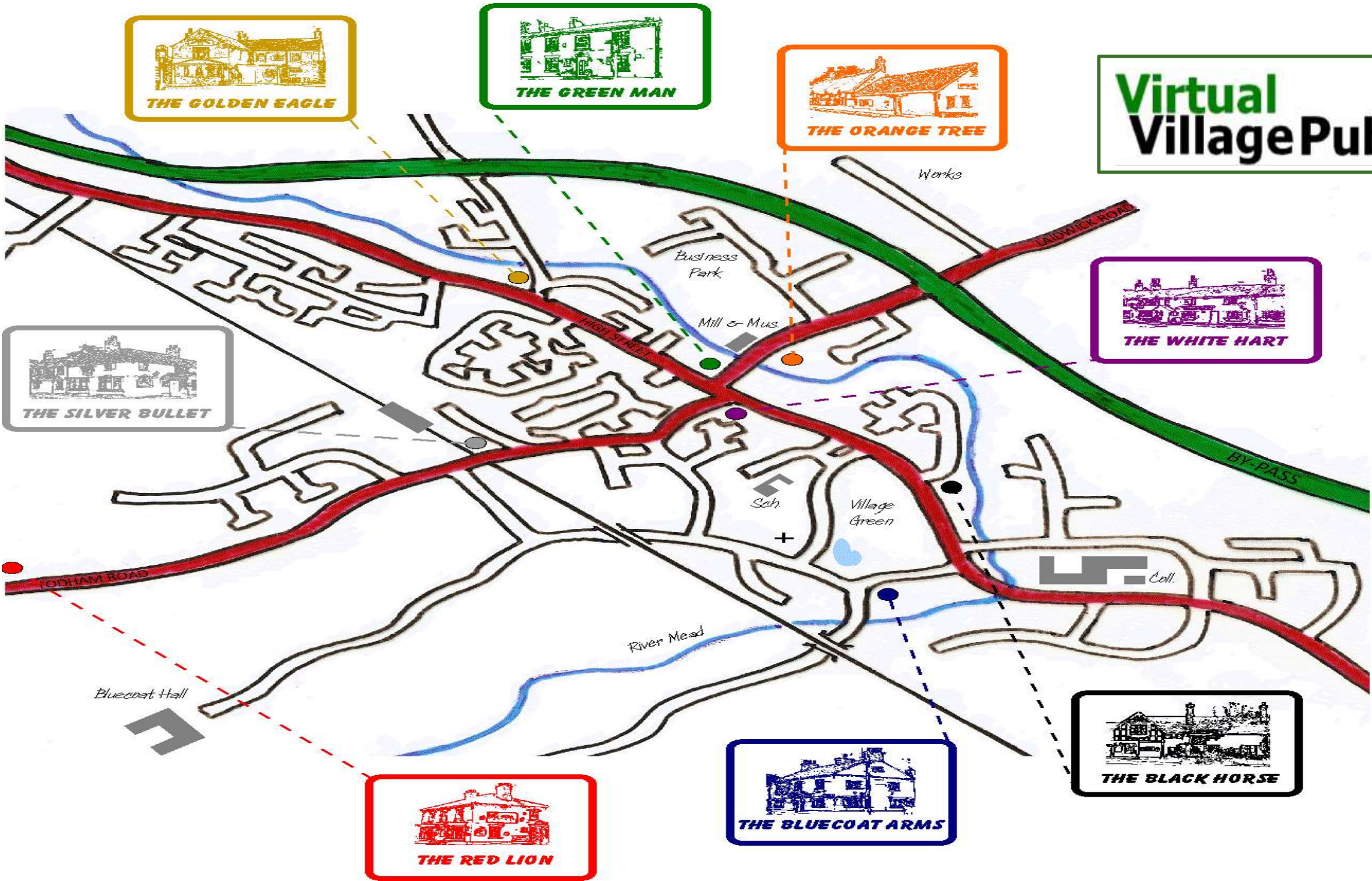
This means:

- **identifying and capturing markets**
- **managing margins**
- **managing overheads**
- **managing resources**





Virtual Village Pub



The **Profit & Loss Account**

The Profit & Loss Account

During a period of time...

- *By how much did our sales exceed our costs?*
- *Where did this 'profit' come from?*
- *What did we do with it?*

The Profit & Loss Account

Three sections:

- **GROSS PROFIT**

What did we make from selling our goods or services?

- **OVERHEADS**

What other costs did we incur during that period?

- **BOTTOM LINE**

What profit did we make overall and what did we do with it?

The Profit & Loss Account

A note on VAT:

- All P&L figures are stated EXCLUDING VAT.

*To take VAT out of a figure, **divide it by 1.20**
(if the VAT rate is 20%)*

The Profit & Loss Account

Section 1: GROSS PROFIT

Sales Revenue on Drinks	100,000
Cost of Sales on Drinks	35,000
Gross Profit on Drinks	<u>£65,000</u>

“During this period, we sold drinks for £100,000 (ex VAT) that we had previously bought from our suppliers for £35,000.”

The Profit & Loss Account

Section 1: GROSS PROFIT

"Matching Principle"

✓ **Cost of Sales
for January** \neq **Stock Purchased
in January** X

Why Not?

*January sales may have included stock
purchased in December*

*January purchases may include stock that will
not be sold until February*

The Profit & Loss Account

Section 1: GROSS PROFIT

To find the **COST OF SALES** figure for January's P&L:

Drinks Stock at 1 st January	5,000
+ Purchases of drinks during January	37,000
- Drinks Stock at 31st January	7,000
= COST OF SALES for January	£35,000

The Profit & Loss Account

Section 2: OVERHEADS

LABOUR COSTS

OPERATING COSTS

ENTERTAINMENT COSTS

MARKETING COSTS

ADMINISTRATION COSTS

BUSINESS RATES

What about 'Depreciation'?

The Profit & Loss Account

DEPRECIATION

Fixed Assets (or Capital Items)

*"Matching
Principle" ?*

Guest Rooms

Gardens

Function Rooms

Playgrounds

Dining Rooms

External Lighting

Car Parks

Internal Refurbishment

10 Years ?

5 Years ?

The Profit & Loss Account

DEPRECIATION

<u>Cost of Car Park</u>	<u>£5,000</u>
Estimated Life of Car Park	10 yrs
Depreciation for the year	£500 / yr
Depreciation for the quarter	£125 / qtr

The Profit & Loss Account

Section 3: THE BOTTOM LINE

***EBITDA =**
Earnings before
Interest, Tax,
Depreciation &
Amortisation

Profit after Tax	7,500
Dividends	<u>2,500</u>
Retained Profit	<u>5,000</u>
(to Balance Sheet)	

Sales	100,000
Cost of Sales	<u>35,000</u>
Gross Profit	65,000
Overheads	<u>50,000</u>
EBITDA*	15,000
<i>Depreciation</i>	<i>2,000</i>
<i>Interest</i>	<i><u>3,000</u></i>
<i>Profit before Tax</i>	<i>10,000</i>
<i>Taxation</i>	<i><u>2,500</u></i>
<i>Profit after Tax</i>	<i><u>7,500</u></i>

The Profit & Loss Account

Section 3: THE BOTTOM LINE

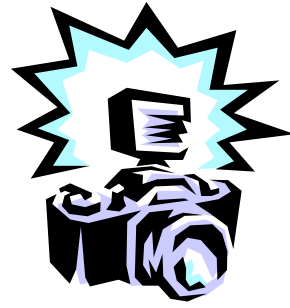
<i>Each unit</i>	Unit Gross Profit	60,000
	Unit Overheads	45,000
	Unit's Net Contribution	15,000



Total Net Contribution	130,000
Central Overheads	40,000
Company Operating Profit	90,000

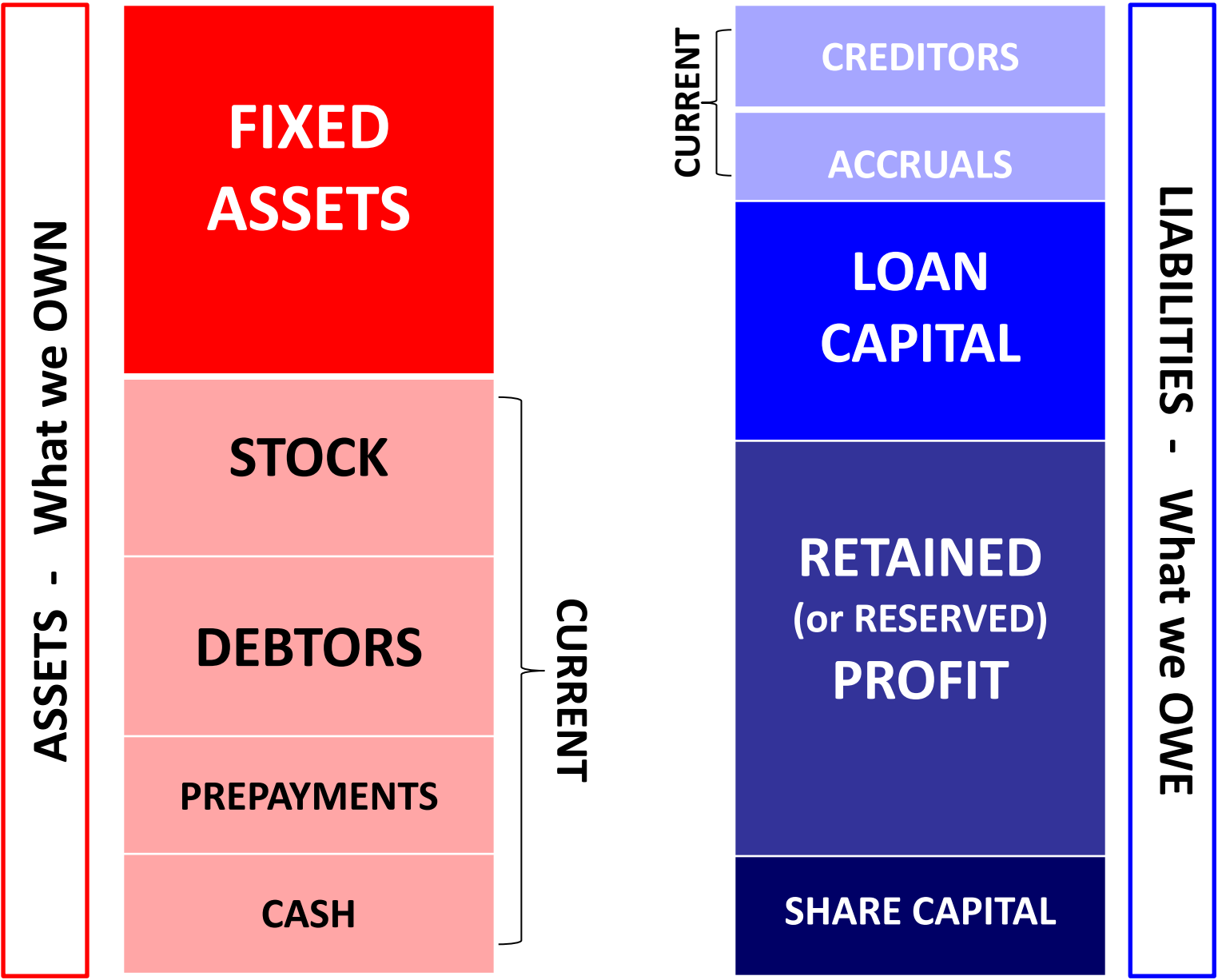
Then take out Interest, Tax, Dividends

The Balance Sheet



A SNAPSHOT OF THE BUSINESS

**BALANCE SHEETS ALWAYS
BALANCE!**



NET ASSETS

**FIXED
ASSETS**

**STOCK
DEBTORS**
PREPAYMENTS
CASH
(CREDITORS)
(ACCRUALS)

“WORKING CAPITAL”

Where the money is sitting

CAPITAL EMPLOYED

**LOAN
CAPITAL**

**RETAINED
(or RESERVED)
PROFIT**

SHARE CAPITAL

Where the money came from

Extra Fixed Assets

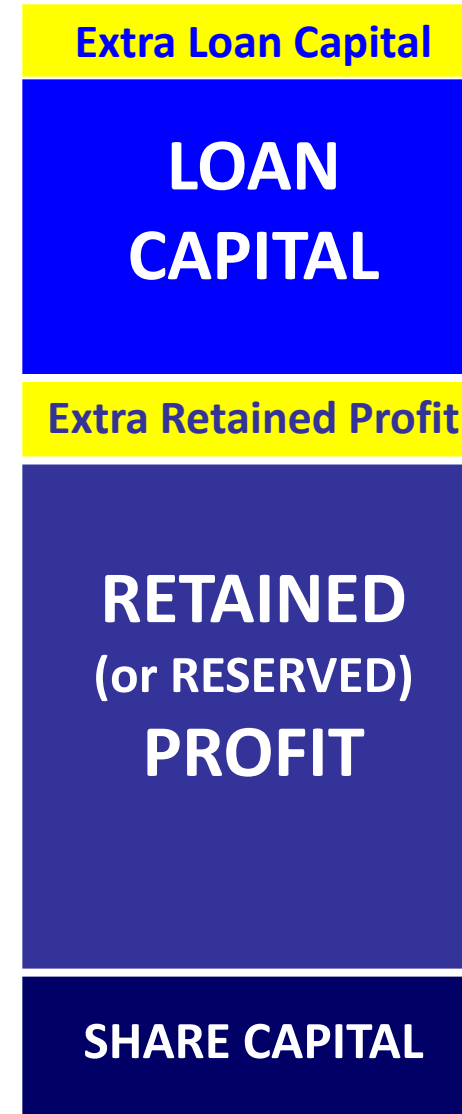
**FIXED
ASSETS**

**STOCK
DEBTORS
PREPAYMENTS
CASH
(CREDITORS)
(ACCRUALS)**

**LOAN
CAPITAL**

**RETAINED
(or RESERVED)
PROFIT**

SHARE CAPITAL



A photograph of a cafe patio with outdoor seating and a building in the background. The patio is filled with white tables and chairs, some with umbrellas. The building in the background has a light-colored facade and several windows. The overall scene is bright and sunny.

The Cash Flow Statement

The Cash Flow Statement

During a period of time...

- *How much did our cash balance change by?*
- *Where did our cash come from?*
- *Where did our cash go to?*

The Cash Flow Statement

Retained Profit for the period **10,000**

Adjustments for the Matching Principle

FIXED ASSETS, STOCK, DEBTORS,
CREDITORS, PREPAYMENTS, ACCRUALS

Adjustments for the Prudence Principle

PROVISIONS MADE OR RELEASED

Adjustments for Funding

SHARE ISSUES, DIVIDENDS PAID,
LOANS TAKEN OUT OR REPAYED

Increase in cash during the period ?

Balance Sheet snapshot

Dec 31st

By how much has the retained profit grown?

Profit & Loss Account for January

By how much has the cash balance grown?

Cash Flow Statement for January

Balance Sheet snapshot

Jan 31st

Key Performance Indicators

“Our Gross Profit Margin is 68%”

BUT....

What was it compared to last month, year?

What was it compared to similar businesses?

What was it compared to our budget?

Two approaches:

- Percentage difference on a particular figure

“Sales have risen by 5% this year”

“Gross Profit is 5% up on budget”

- Ratio of one figure to another over time, against budget etc.

$\frac{\text{Gross Profit (P\&L)}}{\text{Sales (P\&L)}}$

$\frac{\text{Current assets (B/S)}}{\text{Current Liabilities (B/S)}}$

$\frac{\text{Labour cost (P\&L)}}{\text{Sales (P\&L)}}$

$\frac{\text{Stock (B/S)} \times 365}{\text{Cost of Sales (P\&L)}}$

Percentage difference:

$$\frac{\text{New} - \text{Old}}{\text{Old}} \times 100 \quad \text{or} \quad \frac{\text{Change}}{\text{Old}} \times 100$$

If Sales have increased from £50k to £54k

$$\frac{54 - 50}{50} \times 100 = 8\% \text{ increase}$$

If Sales have decreased from £50k to £45k

$$\frac{45 - 50}{50} \times 100 = 10\% \text{ decrease}$$

Ratio of one figure to another:

P&L items as a proportion of the Sales figure

“What happens to every Pound of Sales?”

Gross Profit (P&L)
Sales (P&L)

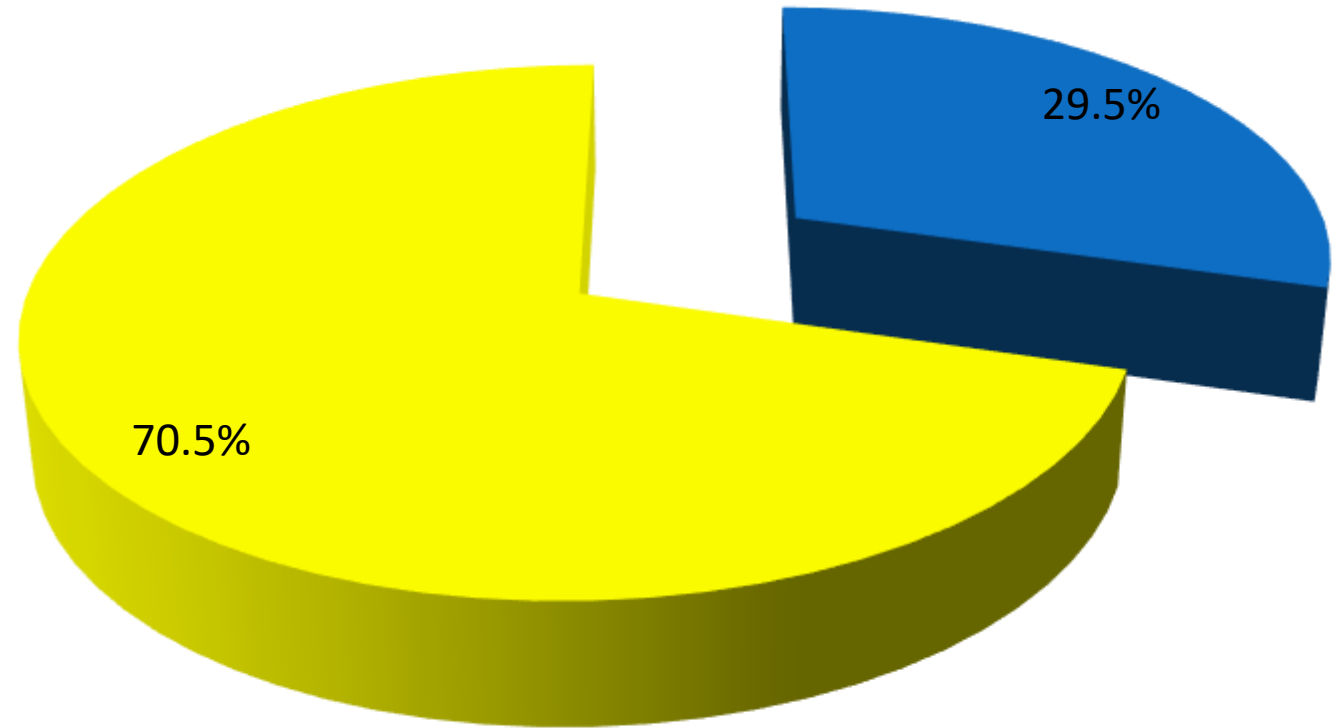
Labour cost (P&L)
Sales (P&L)

Marketing cost (P&L)
Sales (P&L)

EBIT (P&L)
Sales (P&L)

What Happens to Every Pound of Sales?

■ Cost of Sales ■ Gross Profit



Total Gross Profit (P&L)
Total Sales (P&L)

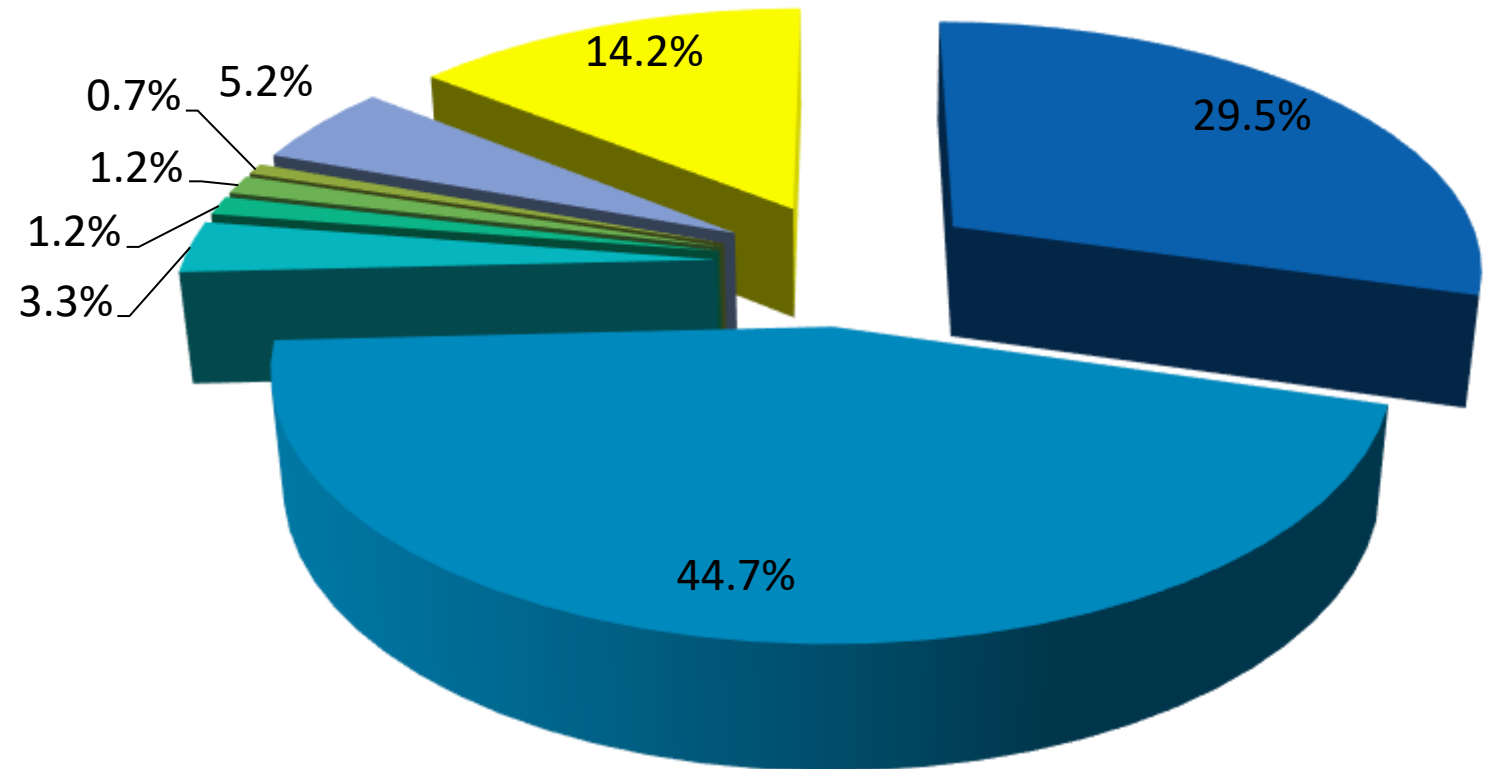
What Happens to Every Pound of Sales?

■ Cost of Sales ■ Labour ■ Operating ■ Entertainment
■ Marketing ■ Administration ■ Property ■ EBIT

Gross Profit (P&L)
Sales (P&L)

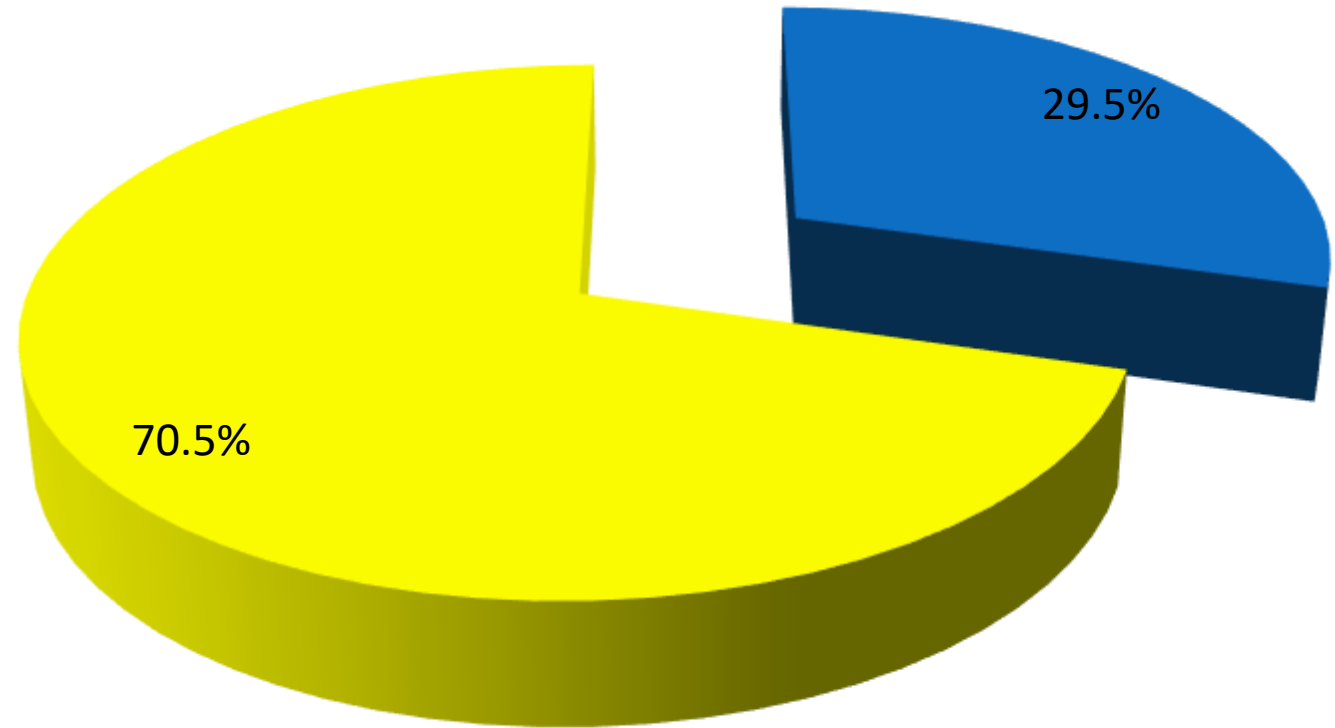
Overheads (P&L)
Sales (P&L)

EBIT(P&L)
Sales (P&L)



What Happens to Every Pound of Sales?

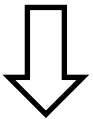
■ Cost of Sales ■ Gross Profit



Gross Profit on Drinks (P&L)
Drinks Sales (P&L)

Gross Profit on Food (P&L)
Food Sales (P&L)

Gross Profit on Hotel (P&L)
Hotel Sales (P&L)



Total Gross Profit (P&L)
Total Sales (P&L)

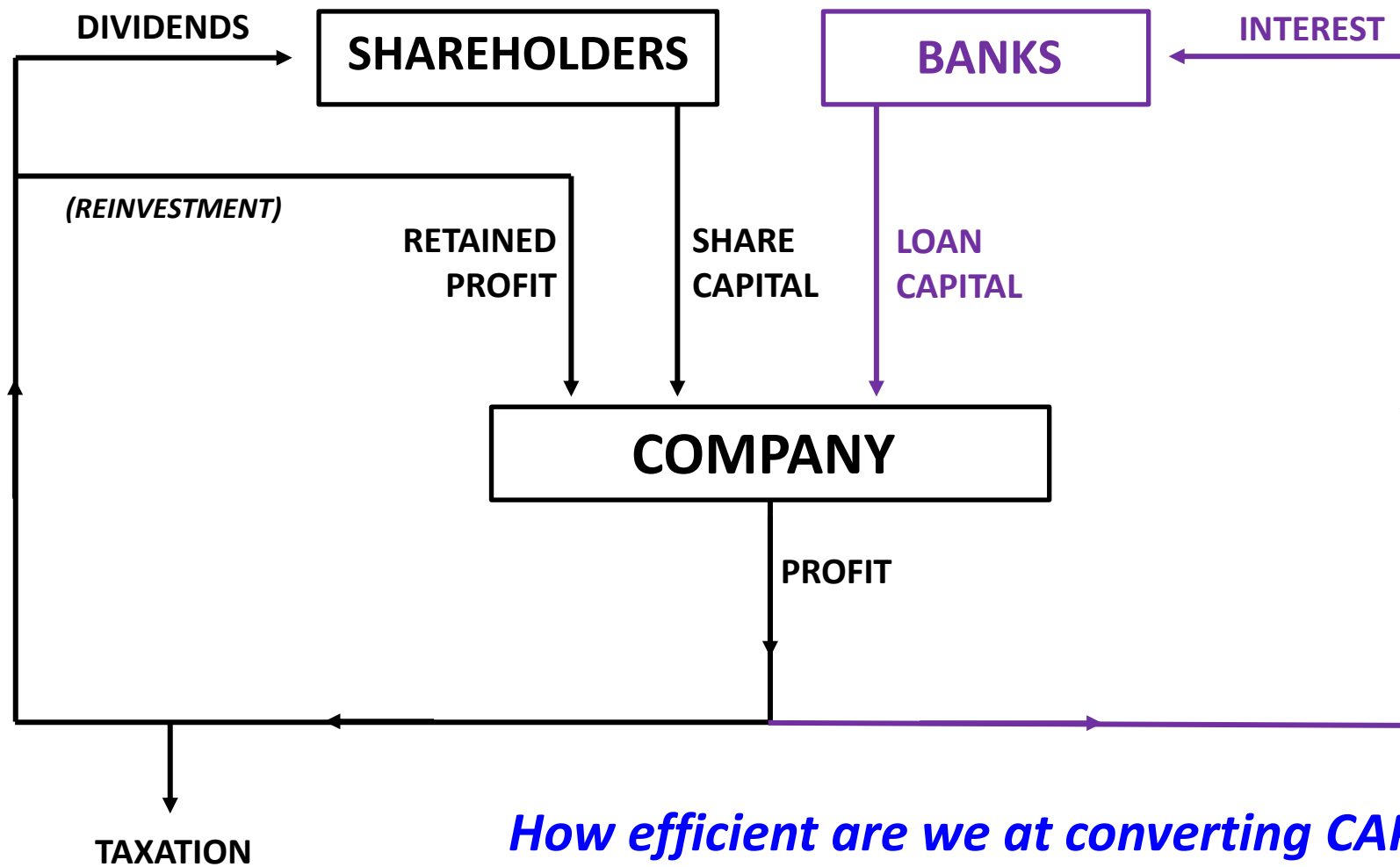
Average Gross Margin

	Sales	
Gross Margin – drink	£40,000	60%
Gross Margin – food	£40,000	70%
<i>Gross Margin – ‘simple’ average</i>	<i>65%</i>	

	Sales	
Gross Margin – drink	£60,000	60%
Gross Margin – food	£20,000	70%
<i>Gross Margin – ‘weighted’ average</i>	<i>62.5%</i>	

$$\frac{(0.60 \times 60,000) + (0.70 \times 20,000)}{80,000} = 62.5\%$$

Key Performance Indicators (2)



How efficient are we at converting CAPITAL into PROFIT?
*What is our level of... **PROFITABILITY**?*

Return on Capital Employed (ROCE)

“Profitability”

- *How good are we at converting capital into profit?*
- *How many pence of profit for every pound tied up in the business for a year?*

$$\frac{\text{Earnings for the Year (P\&L)}}{\text{Capital Employed (B/S)}} \times 100\%$$

Return on Capital Employed (ROCE)

	Company A	Company B
Profit	£20m	£20m
Capital Employed	£100m	£1000m
ROCE	20%	2%

Maximising Profitability = Highest Profit for the Lowest Capital

Key Performance Indicators (3)

Three Battlegrounds for Commercial Success



- The Drinks Market
- The Food Market
- The Hotel Market

Three Battlegrounds for Financial Success



- **Value of Sales**

How many pounds of sales are we making?

- **% Profits**

What % of every pound is left after covering all our costs?

- **Capital**

How much money have we had to tie up in the business in order to deliver our profit?

Quarterly Focus



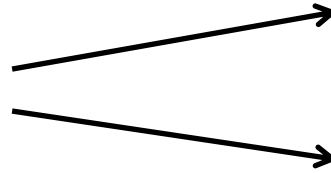
SALES

% PROFITS

GROSS MARGINS

OVERHEADS

CAPITAL





- 1 **SALES:** *What is our market share **compared to the average** (ie 12.5%)?*
- 2 **MARGINS:** *What % of every pound of sales do we have left after paying for the stock, **compared to our competitors**?*
- 3 **OVERHEADS:** *How many pence in every pound of sales get spent on the overheads, **compared to our competitors**?*
- 4 **CAPITAL:** *How much capital have we tied up in our business, **compared to our competitors**?*

RATIO TRACKER

		Autumn	Winter	Spring	Summer
SALES					
Pub's Share					
Average Share		12.5%	12.5%	12.5%	12.5%
MARGINS					
Drinks margin	This Pub				
	Market avg				
	+ or -				
Food margin	This Pub				
	Market avg				
	+ or -				
Average margin	This Pub				
	Market avg				
	+ or -				
OVERHEADS					
Labour	This Pub				
	Market avg				
	+ or -				
Operating	This Pub				
	Market avg				
	+ or -				
Entertainment	This Pub				
	Market avg				
	+ or -				
Marketing	This Pub				
	Market avg				
	+ or -				

Key Performance Indicators (4)

Stock Days



- *How much stock have we got,
relative to sales?*

$$\frac{\text{Stock (B/S)} \times 365}{\text{Cost of Sales (P\&L)}} = \text{no. days}$$

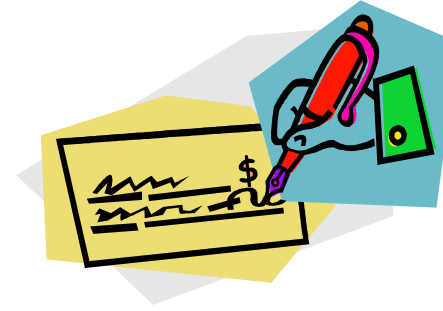
Debtor Days



- *How long are we taking, on average, to get the money in from our credit customers?*

$$\frac{\text{Debtors (B/S)} \times 365}{\text{Credit Sales (P\&L) + VAT}} = \text{no. days}$$

Creditor Days



- *How long are we taking, on average, to pay our suppliers?*

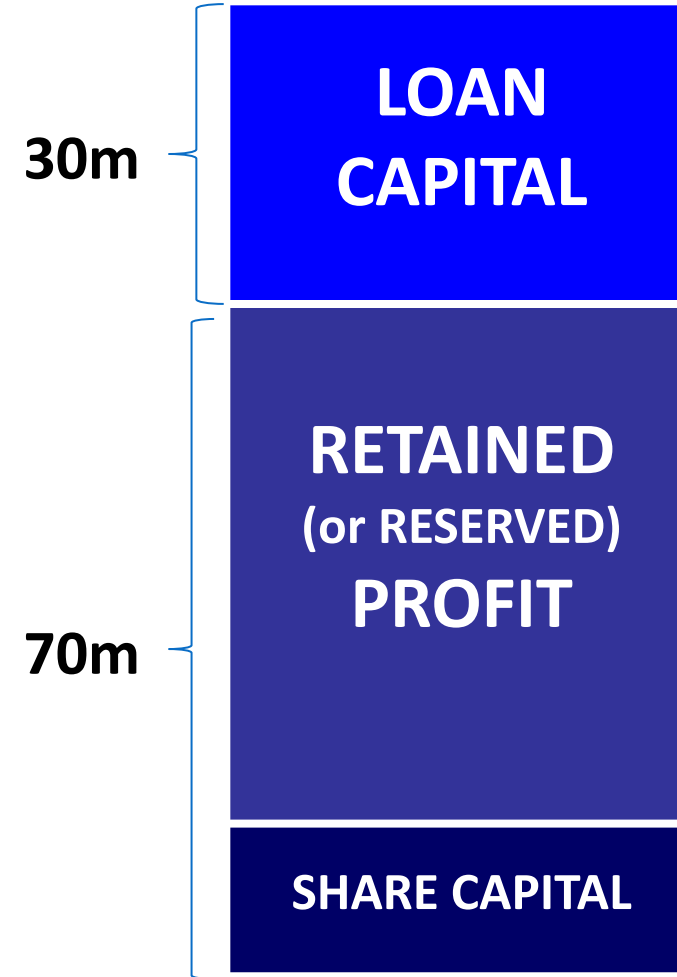
$$\frac{\text{Creditors (B/S)} \times 365}{\text{Cost of Sales (P\&L) + VAT}} = \text{no. days}$$

Gearing

- *What proportion of the business is “owned” by the bank?*

$$\frac{\text{Loan Capital (B/S)}}{\text{Total Capital (B/S)}}$$

$$\frac{\text{£30m}}{\text{£100m}} = 30\%$$



Gearing

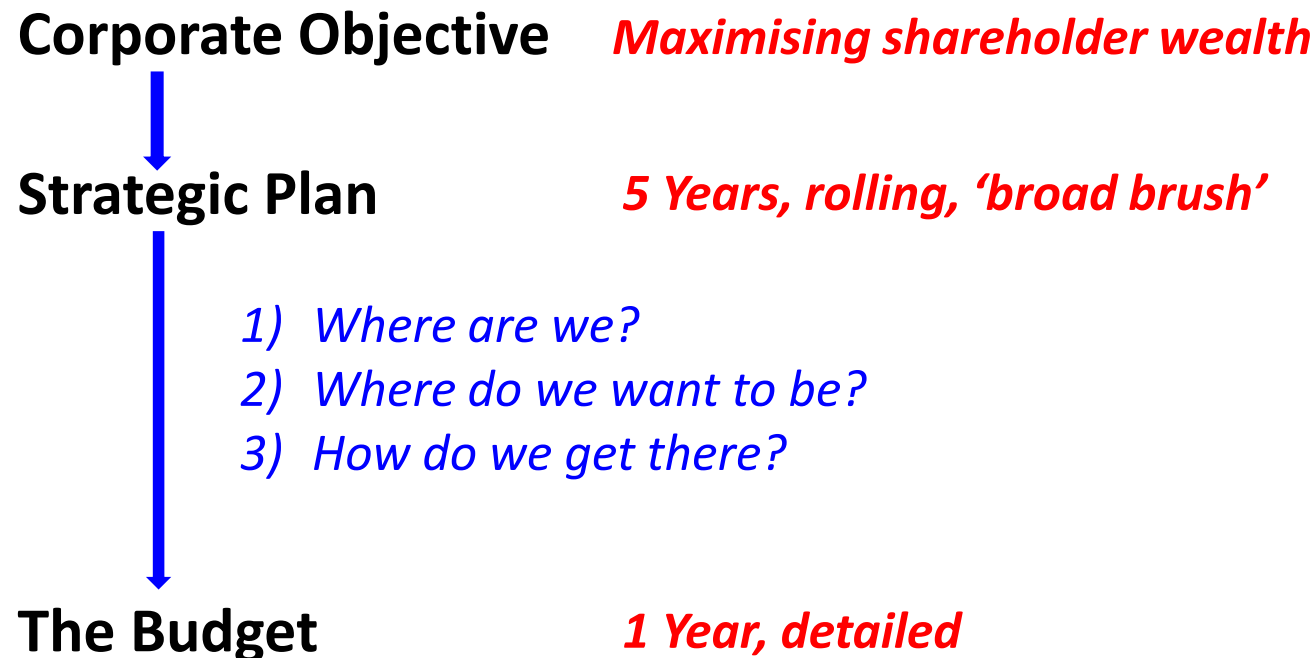
- Risk versus Reward
 - *Higher borrowings mean higher interest*
 - *Higher borrowings mean more capital available for growth.*

Budgeting

What is a Budget?

“A plan, quantified in monetary terms, prepared and approved prior to a defined period of time, usually showing planned income to be generated and/or expenditure to be incurred during that period and the capital employed to attain a given objective.”

Chartered Institute of Management Accountants



Why do we Budget?

- *Charts a route to achieving the strategic plan*
- *Control mechanism – are we on track?*
- *Forces us to plan, avoids always thinking about today's problem*
- *Allocates scarce resources*
- *Authorisation mechanism*
- *Motivational tool*
- *Parcels up responsibility*
- *Co-ordinates functions in a complex business*
- *Plans cash requirements*
- *Communicates ideas and plans – goal congruence*
- *Satisfies providers of funds – investors, banks, parent co's*
- *Good corporate governance*

How do we Budget?

- *Consistent with the strategic plan*
- *Realistic but challenging*
 - *Demotivation/failure versus complacency/waste/'under-performance'*
- *Wide participation*
- *Understand costs – fixed/variable, seasonality*
- *Formalise contingencies*
- *Adequately resourced process*
- *Use historical data but consider what's changed:*
 - *Your strategy, facilities, reputation*
 - *Your competitors*
 - *Your suppliers and their costs*
 - *External factors – the economy, laws, taxes*
 - *Allow for non-repeating events*
 - *Can we improve?*

Budgetary Control

Review: *Variance Analysis Report*

- React:**
- *Is it big enough to worry about?*
 - *Is it correct?*
 - *Do we already know about it?*
 - *Is it just a phasing variance? - “shove a 12th in each month”*
 - *Is it a one-off or part of a trend?*
 - *How do we recover?*
 - *Who else needs to know?*
 - *Control issues to address?*
 - *Justified?*
 - *Lessons for next year’s budget?*

Revise: *Re-Forecast from first (?) quarter*

Where do we now expect to finish the year?

Working Capital

- Stock

High Stock: the Rewards

- *Can quickly supply what the customer wants, meaning Happy Customers and repeat business.*
- *Can benefit from bulk discounts and avoid emergency orders*
- *Can cope with sudden surges in demand*
- *Can cope with disruption to supply – strikes, weather etc*
- *Can hedge against inflation if the price is going to rise*
- *Fewer, larger orders can mean less administration cost per unit and smaller carbon footprint.*

High Stock: the Risks

- *It's dead money – the 'opportunity cost' (benefit foregone)*
- *Risk of write-downs*
 - *Physical deterioration*
 - *Technological obsolescence*
 - *Changes in fashion*
 - *Date-sensitive stock*
 - *Customer-specific stock*
- *Human cost of handling, counting, securing*
- *Storage cost – space, refrigeration?*
- *Prices may fall rather than rise*
- *Insurance cost, risk of catastrophe*
- *Commercial inflexibility*

Squaring the Circle

- *Good sales forecasting*
- *Accurate planning of purchasing and production*
- *Shortening lead times*
- *Flexible production process*
- *Smaller range*
- *Fewer components*
- *Harnessing technology to provide good information*
- *Just-in-Time deliveries*
- *Consignment stocks*

Working Capital

- Debtors

Debtors

Longer credit terms can give a competitive edge but...

- *Debtors represent dead money – ‘opportunity cost’ and potential cashflow problems*
- *Higher debtors mean more risk of default*
- *Higher debtors involve more administration*

***BUT...** avoid giving away margin just to get the money in more quickly – early payment discounts come straight off the profit.*