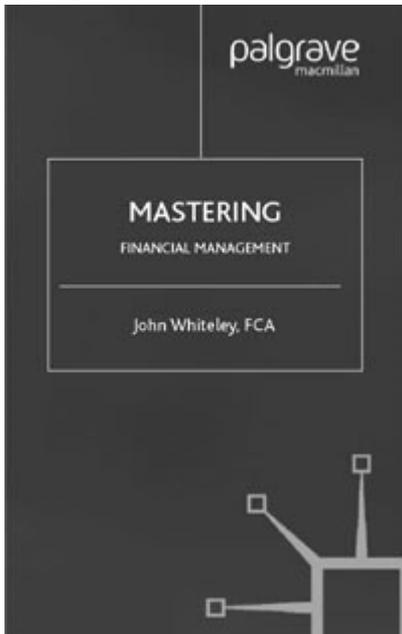


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Mastering

Financial management

John Whiteley, FCA

Business Series Editor

Richard Pettinger

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Preface

The financial director or manager is a key player in the management of any business or other organisation. Finance is one of the major resources which have to be managed well to ensure the success of the organisation.

In this book, I have brought together the main elements of financial management. I have dealt with the practical aspects as well as the academic ones. The book should therefore be of use to students, to those managing their own smaller businesses, and to those already in positions of some responsibility in financial management of larger organisations. I have drawn on over 25 years' experience as a practising Chartered Accountant.

The names of the businesses used in examples and exercises are fictional, and if any businesses exist bearing those names, I apologise – this is entirely unintentional, and does not imply any knowledge of those businesses.

I have enjoyed writing this book, and hope that you will enjoy – and benefit from – reading it.

JOHN WHITELEY

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Introduction

Taking control

Finance is one of the most important resources of a business, or indeed any organisation. The management of finance is the subject of this book. The key to management of any resource is the ability to take control of it. Throughout this book, you will find slogans, to encapsulate important key ideas. Here is the first, which will be repeated in several different contexts:

► If you can measure it, you can control it.

The key to control, in finance as in any other area, is accurate measurement. In order to measure things accurately, certain techniques must be learnt. Those techniques form the bulk of the rest of this book. The

chapters include examples, discussion questions and exercises to work through, with answers at the end of the book.

The art and craft of financial management

This subject is not simply a matter of learning techniques. Certain personal attitudes of mind and interpersonal skills must be cultivated. To a large extent, these come with experience, but it is worth pointing out some of the basic elements here.

Financial management requires an attitude of mind which can be summarised by:

► Take nothing for granted. Question everything.

For example, when dealing with cost accounting, it is vital to understand the nature of each individual cost element. A costing system is a model of the business as a whole. Financial managers must understand the data.

Retaining integrity

It is essential to instil confidence in those with whom you deal. In his dealings with you, a bank manager will certainly be assessing the person as much as the business. Different groups – shareholders, customers, suppliers, employees,

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lenders, board members – will have different expectations, which must be balanced against each other.

Understanding and balancing these expectations often calls for real interpersonal skills.

Profitability is the key to business survival – without it, there will not be a business to continue. However, the moral and ethical dimension to managing finance must be cultivated, too. Honesty and integrity must come before financial gain – either personally or for the business. To retain the trust of other board members, investors, and employees, all communications must be transparently honest and open.

The long-term interest of the business – and thereby of the shareholders – should be constantly in view.

Short-term decisions often conflict with the long-term prospects of the business. Any business also has a wider responsibility to the environment, to society, and to the local community. A financial manager who can manage all these aspects will earn the respect of others who matter to the organisation, and build up a reserve of goodwill, which is one of the most important assets to bring to management.

Good communication should never deteriorate into ‘spin’ or manipulation of the facts and figures. Too many financial scandals and frauds have been the result of deliberate misrepresentation of figures, and, hence, misleading information. In recent history, the names ‘Enron’ and ‘Worldcom’ should be enough to remind all financial managers that the ultimate goal of communicating financial information is to present the situation as it really is.

Personal relationships

Managing finance involves co-operation with shareholders, with other people in the business, with customers and suppliers, and with bank managers or other lenders.

Current wisdom is that finance directors should not just be the mileometer of the business (i.e. measuring past performance), but they should start to become the engine – driving the business. For larger businesses, and particularly for publicly quoted companies, that emphasis has a bearing on the relationship between the financial director and the chief executive. Trust and respect between these two key people is vital.

This book also touches on various non-financial areas of management. This is not accidental, or a mistake.

Understanding of other areas is vital to financial management.

Developing communication skills

Financial managers must learn communication skills. In essence, this means ensuring that the listener or reader understands the same message as the financial manager wishes to convey. They must communicate with

other managers,
other employees,
directors,

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investors, and
the public.

This requires an ability to express one's self clearly in written or spoken English, as far as possible without jargon. In finance matters particularly, and especially when dealing with board members or other managers, members of the audience are often embarrassed to ask for an explanation of something not understood. They may think that they should understand it, and be embarrassed at any lack of understanding.

Here is a golden rule of communication:

► Never underestimate the intelligence of your audience, but never overestimate their knowledge of your specialist subject.

More than that, communication requires the ability to establish the key facts: to distinguish the relevant from

the irrelevant, the material from the immaterial, the core from the peripheral. Oscar Wilde said that facts are 'seldom pure and never simple'. Facts – especially financial ones – usually need interpretation. The skilful financial manager will be able to offer meaningful comment on the implications of the choices put before the audience – whether that audience be the board of directors, other managers, or shareholders.

Timeliness is essential in presenting reports that are needed to control the business and as the basis for decision making. Many financial disasters could have been avoided if those responsible for presenting financial information had communicated it at the right time. Directors and shareholders depend on financial managers to spot potential problems and crises before they materialise.

I have written this book assuming that the reader has no prior knowledge of the subject, and tried to avoid jargon, and explain concepts simply. There is a glossary of key terms at the end of the book, and a list of websites that I hope will prove useful for further investigation. In particular, the companion website for this book gives much more information relating to the subjects covered. The website address is www.palgrave.com/masterseries/whiteley

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Understanding accounts

LEARNING OUTCOMES

By the end of this chapter, you should be able to:

- ▶ understand the types of financial statements produced, and the needs of their users,
- ▶ identify the components of financial statements, and their significance,
- ▶ appreciate the benefits of comparisons with other figures – both internally and externally,
- ▶ understand the key ratios used in statistical analysis, their uses and limitations, and
- ▶ adapt these methods to non-profit organisations.

Introduction

This chapter explains how to interpret accounts. They are not just a set of figures on a piece of paper, without any context. A financial manager must be able to see the reality behind the figures. In this chapter we examine different types of accounts, and what they mean. Comparisons, ratios and statistical analysis are the tools which we shall start to learn to use. We also look at performance measures for non-profit organisations.

What is behind the figures?

A casual reader may look at financial statements, go straight to the bottom line to see what the profit is, and leave it at that. A more interested person might look at the turnover figures to see how the sales are going. Many people do not get further than a cursory glance because they do not understand the intricacies of the relationships between the various figures in the financial statements.

Types of accounts

Financial statements which are issued once a year for the benefit of shareholders or proprietors, and lodged with Companies House are generally called the annual accounts. These are really for external consumption. In the case of companies, they can be subject to audit, dependent on the size of the company,

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and they may not appear promptly after the end of the financial period (which is usually a year).

In contrast, internal financial statements, generally known as management accounts, are not intended for the general public or even shareholders. They are produced for the benefit of managers, and should be made available extremely promptly after the end of the accounting period to which they relate. The accounting period used for management accounts is usually monthly, although for some smaller businesses, it could be quarterly.

Components of accounts

Whatever type of financial statement is under consideration, it will consist of a profit and loss account and/or a balance sheet. Accountants may expand on these forms, or adapt them to suit the purpose for which they are prepared, but they are essentially variations of the same thing.

A typical set of accounts, in abbreviated form, is shown in Figure 2.1. These consist of a profit and loss account, and a balance sheet. The figures for the immediately preceding period are shown for comparison. By commonly accepted convention, these comparative figures are shown on the right hand side of the current figures.

Profit and loss account

This account is always stated to be for a period, which is usually, but not always, a year.

Income

The profit and loss account shows the gross income, also known as turnover. This will consist mainly of the core income, whether from sales of products or services, or some other form. Other income from incidental sources is shown separately.

Direct costs

The direct costs (cost of sales) are deducted from the gross income to give the gross profit. As we shall see below, this gross profit figure is a key figure in the accounts. The percentage relationship of the gross profit to turnover is a key business indicator.

Overhead expenses

Overhead expenses are categorised into the different types of expense, and these categories, such as administration, property, transport, finance, and so on, are also useful in getting an insight into the business, and how it runs. The overhead expenses are deducted from the gross profit to arrive at the net profit, or net loss. The relationship of net profit to turnover is also a key business indicator.

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Profit and loss account for the year ended 31st December 20xx

	Current year		Previous year	
	£million	£million	£million	£million
Sales		500		450
Cost of sales		300		250
Gross profit		200		200
Other income		5		2
		205		202
Overheads		110		104
Net profit		95		98
Taxation	30		30	
Dividends	40		35	
		70		65
Retained profit		25		33

Balance sheet as at 31st December 20xx

Fixed assets		400		350
Current assets	130		114	
Current liabilities	65		59	
Working capital		65		55
		465		405
Long-term liabilities				
Loans		80		85
Net assets		385		320
Capital				
Share capital		150		120
Share premium		10		
Profit and loss account		225		200

Figure 2.1 Specimen company accounts for the year ended 31st December 20xx

Appropriations

Appropriations of profit are deducted from the net profit (or loss). The most usual appropriations of profit are dividends and taxation, leaving a final figure expressed as retained profit (or accumulated losses). That is to say, it is the profit not paid away in taxation or in dividends to shareholders, and therefore retained in the business.

The profit and loss account, therefore, shows the result of the business activities for the period. For other 'not for profit' organisations, a similar account is prepared. However, because the organisation is not for profit, the account is called an income and expenditure account. It is highly unlikely that the income will exactly match the expenditure, so the excess of income over expenditure is called a surplus, and an excess of expenditure over income is called a deficit.

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EXERCISE 2.1

In Figure 2.1, identify the following (for both years):

Turnover

Total income from all sources

Total appropriations

Balance sheet

The balance sheet is always stated as at a particular date, which is always the final date of the period for which the profit and loss account is prepared.

The balance sheet shows the financial position of the business at the date shown. The assets are stated, and liabilities are deducted from them, leaving the net assets of the business.

Capital

The net assets are represented by the capital of the business. In a limited company, this capital includes the share capital, and there may also be a share premium account (representing monies paid by shareholders in excess of the nominal value of the shares). The other element of capital is the accumulated reserves of the profit and loss account. There could also be other capital reserves, which are sometimes created when assets are revalued, and similar transactions.

In an unincorporated business, such as a partnership or a sole trader, the capital is made up of the capital accounts of all the proprietors, i.e. the sole trader or the partners. This capital consists of the money put into the business by the proprietors, added to their shares of profits, and from which any monies drawn out of the business are deducted.

Whatever the form of the business, the capital will always be equal to the net assets of the business.

Another way of looking at the correspondence between the net assets and the capital is to say that the capital is the sum that is invested in the business by the shareholders or proprietors. The concrete expression of that investment, in terms of assets and liabilities, is shown in more detail in the balance sheet.

Fixed assets

These are long-term assets of the business, consisting of tangible and intangible assets.

Tangible assets

These are assets which can actually be seen and touched, as the name suggests. They include things like land and buildings, plant and machinery, vehicles, and so on.

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Intangible assets

These are things which do not have a physical existence – such as goodwill, patents and so on.

Depreciation

All fixed assets are subject to depreciation, which is written off the value of these assets each accounting period. This, in effect, spreads the cost of the assets over their useful lives.

Current assets

These are short-term assets which by their nature change from day to day – even from hour to hour – in the course of business. They include things like the bank balance, monies owing from debtors, stock, and expenses paid in advance.

Current liabilities

These are the short-term liabilities of the business, a counterpart to the current assets. Like them, they change from day to day in the course of business. They include such things as bank overdrafts, current instalments on hire purchase contracts or loans, monies owing to creditors, and expenses which have accrued. Current liabilities are generally recognised as those which fall due within one year of the balance sheet date.

Working capital

The difference between current assets and current liabilities (net current assets) is known as working capital. The management of this will be considered in more detail in Chapter 5. If the current liabilities are greater than the current assets, the difference is known as a working capital deficit. A working capital deficit could mean that the business is insolvent, although this is not necessarily true – particularly in businesses operating on a largely cash basis, such as retail shops. Insolvency means that the business is unable to meet its current liabilities as they become due.

Long-term liabilities

These are liabilities which are due for payment more than one year after the balance sheet date. They include things like long-term loans, and later instalments on loans and hire purchase contracts.

Net assets

This is simply the net sum of all the assets less the liabilities of the business. If the total liabilities exceed the total assets, then the business has net liabilities. It is also, of course, a sign of financial weakness, at the very least, and could indicate the financial collapse of the business.

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EXERCISE 2.2

In Figure 2.1, identify the following (both years):

Working capital (net current assets)

Total gross assets

Total capital

Comparisons

Internal comparisons

The figures do not exist on their own, independently of anything else. They are at their most useful when shown in comparison to something else. The most common comparisons are between the current and corresponding previous accounting periods, and of actual with budgeted figures.

The comparison with the previous period will show what progress, or otherwise, has been made. The comparison of several preceding periods will show trends. Trends may be indicative of growth or decline, or they may follow cyclical patterns, which may mirror the economy of the country generally, or they may be peculiar to the specific trade or industry.

The comparison with budget will show how far plans and targets have been achieved. We consider budgets in more detail in Chapter 4.

Internal comparisons show the relationships of various figures to each other. These are considered in more detail in the section dealing with statistical analysis and key ratios.

EXERCISE 2.3

What key features of the business can be gleaned from the comparison of the current year's figures in Figure 2.1 with the previous year's figures?

External comparisons

The figures and ratios can also be compared with those in competitors' financial statements. This could show that other businesses may be performing better in certain areas than your own business, or worse. Action can be taken to remedy situations which can be improved upon. The theory is that if one, or several other businesses can perform better in a certain area, then that better performance must be achievable.

How is it possible to obtain access to competitors' accounts? All companies must file accounts with Companies House, and it is possible to search the records of other companies to look at their figures.

However, the information filed at Companies House is often minimal. The requirements for accounts to comply with the Companies Act allow just the bare bones to be published. Many of the detailed figures are not in the public realm.

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Many industries or business sectors have organisations which carry out surveys of key figures and ratios. To do this, they need access to figures that are not generally available at Companies House. However, most companies would not be happy at releasing details of their most sensitive and confidential figures. Therefore, the organisations which carry out these inter-business comparisons guarantee complete security and anonymity. They collate all the figures from different businesses and produce tables showing the average, median, top, middle and bottom quartiles, and so on. Each business will then also receive its own individual figures to show where it appears in the 'league table'. This enables action to be taken on those areas in which performance is low.

Always bear in mind, however, that very few, if any, consolidated accounts have similar characteristics these days, so there must be a large element of discrimination.

Statistical analysis and key ratios

By comparing different figures within the set of accounts, certain key ratios and relationships can be measured. These provide useful pointers to areas where business performance and profitability can be improved. Detailed examination of the key ratios and relationships often leads to more searching questions about various areas of business performance.

The key ratios shown here will be illustrated by reference to the specimen financial statements shown in Figure 2.2, which is an expanded form of the information given in Figure 2.1. The extra column shows the budget figures for the current year. The presentation is not in strict Companies Act format, but drawn up to illustrate the ratios.

The reference letters on each line to the right of the current year figures are used for identification in the explanations below.

Profit ratios

Gross profit percentage

The ratio of the gross profit to the sales (or turnover) is one of the most important key ratios for any business, of whatever type. It can be adapted to manufacturing, wholesale, retail, and even service businesses.

The gross profit (f) is calculated by deducting the cost of sales (e) from the sales turnover (a). The gross profit percentage is the gross profit (f) expressed as a percentage of the sales turnover (a). The formula is therefore:

$$\frac{f}{a} \times 100$$

In the example, the gross profit percentage is 40%, compared to 44.4% in the previous period and 43.6% in the budget.

This gross profit percentage can be further analysed to find out the reasons for any variations from the expected figure. There are several reasons for variations in gross profit percentage, including:

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Profit and loss account

	Current year			Previous year		Budget	
	£million	£million		£million	£million	£million	£million
Sales		500	a		450		550
Cost of sales							
Materials	150		b	120		150	
Direct labour	100		c	80		110	
Factory costs	50		d	50		50	
		<u>300</u>	e	<u>250</u>			<u>310</u>
Gross profit		200	f	200			240
Other income		5		2			3
		<u>205</u>		<u>202</u>			<u>243</u>
Overheads							
Property	20		g	15		20	
Salaries	30		h	28		32	
Maintenance	10		i	12		12	
Administration	5		j	6		5	
Transport	10		k	11		9	
Marketing	10		l	9		10	
Depreciation	10		m	9		10	
Interest	15		n	14		15	
Total overheads		<u>110</u>	o	<u>104</u>			<u>113</u>
Net profit		95	p	98			130
Taxation	30		q	30		40	
Dividends	40		r	35		45	
		<u>70</u>		<u>65</u>			<u>85</u>
Retained profit		<u>25</u>	s	<u>33</u>			<u>45</u>
Balance sheet							
Fixed assets		400	t	350			390
Current assets							
Stock	40		u	35		45	
Work in progress	10		v	9		10	
Debtors	60		w	55		55	
Cash and bank	20		x	15			20
	<u>130</u>		y	<u>114</u>			<u>130</u>
Current liabilities							
Trade creditors	40		z	37		40	
Taxes	10		aa	8		12	
HP instalments	5		ab	6		4	
Overdraft	10		ac	8		5	
	<u>65</u>		ad	<u>59</u>		<u>61</u>	
Working capital		<u>65</u>	ae	<u>55</u>			<u>69</u>
Total assets less current liabilities		465		405			459
Long-term liabilities							
Loans	80		af	85		70	
Net assets		<u>385</u>	ag	<u>320</u>			<u>389</u>
Capital							
Share capital							
Preference shares	50		ah	50		50	
Ordinary shares	100		ai	70		82	
	<u>150</u>		aj	<u>120</u>		<u>132</u>	
Share premium	10		ak			20	
		160	al			152	
Profit and loss account		<u>225</u>	am	<u>200</u>		<u>237</u>	
Shareholders' funds		<u>385</u>	an	<u>320</u>		<u>389</u>	

Figure 2.2 Specimen company accounts for the year ended 31st December 20xx
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Sales mix: The mix of products included in the total sales may have shown a variation which could affect the overall gross profit percentage. For example, some lines may carry a higher profit mark up than others. A typical corner shop might sell tobacco products, confectionery, newspapers, and greetings cards. The mark

up on tobacco would usually be much less than the mark up on greetings cards and confectionery. Thus, a change in the relative volumes of sales would affect the overall percentage.

Increased competition: Competition may force price cuts, with no corresponding cut in the cost of sales. This would adversely affect the gross profit percentage.

Increased materials cost The cost of raw materials may have risen, with little or no chance of passing these increases on to customers by increasing sales prices.

Cost of sales analysis

Since the gross profit is calculated by deducting the cost of sales from the sales turnover, it follows that the cost of sales expressed as a percentage of the sales turnover is complementary to the gross profit percentage. Thus, in the example, the current year's gross profit percentage is 40%, so the cost of sales percentage is 60%. This can be checked by calculating the cost of sales (e) as a percentage of the sales turnover (a). The formula is:

$$\frac{e}{a} \times 100$$

Where the cost of sales is made up of several items, the various components can be compared separately. Thus, in the example in Figure 2.2, the total cost of sales is £300 million, or 60% of turnover. Further analysis can be carried out to show the relative percentages of materials, direct labour, and factory costs. This would yield the following results:

	Percentage of sales		
	<i>Current year</i>	<i>Previous year</i>	<i>Budget</i>
Materials (b × 100/a)	30%	26.7%	27.3%
Direct labour (c × 100/a)	20%	17.8%	20%
Factory costs (d × 100/a)	10%	11.1%	9.1%

Each of these variations, particularly against the budgeted figures, can then be investigated. Most of the direct costs are variable costs – that is to say, they vary in direct proportion to the sales. Therefore, it would be expected that the percentage relationship of these items to the sales would remain constant. Thus, where there is a significant variance – as in the above example, for materials cost – the cause should be investigated. For instance, the increase could be due to a volume variance, or a cost variance, compared to both the previous year and the budgeted figure.

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A volume variance means that the amount of materials used, or paid for and not used, has varied. This could be due to some malfunction in the manufacturing process, or other reasons such as wastage, loss or pilferage of materials.

A cost variance means that the same volume has cost more than either the previous year or the budgeted amount, and this should lead to steps being taken to control costs.

However, some of the direct costs may have an element of fixed cost, and this is particularly so in the case of direct labour and factory costs. These percentages may therefore be affected by the volume of sales and activity. The control issues here are therefore different from the control of items which are fully variable.

This process of cost analysis provides a good example of the principle seen in the introduction, which it is worth reiterating:

► If you can measure it, you can control it.

Detailed gross profit analysis

The analysis of cost of sales and of gross profit margins may also be extended to cover more complex situations with different products, departments or sales lines.

EXERCISE 2.4

High Street Motors sales consist of the following elements:

Fuel and oil sales

New car sales

Second hand car sales

Servicing and spares sales

The various items of sales and cost of sales are grouped into those categories to provide an analysis of the gross profit of each department. The analysis is illustrated in Figure 2.3. This analysis can be used to highlight areas in which the performance of the departments can be compared with each other for the current year, with the previous year's figures and with the budgeted figures.

What issues might be raised from this analysis?

Net profit percentage

This is a similar calculation to the gross profit percentage. However, it measures the net profit before tax and dividends or other distributions (line p in Figure 2.2) as a percentage of the sales. The formula is:

$$\frac{p}{a} \times 100$$

In this case, the figure is 19%, compared with the previous year's percentage of 21.8%, and the budgeted figure of 23.6%. This percentage can vary much more than the gross profit percentage.

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Total figures	Current year		Previous year		Budget
	£million	£million	£million	£million	
Sales		600		610	660
Cost of sales					
Materials	370		360		398
Direct labour	78		75		75
Direct costs	21		22		22
		<u>469</u>		<u>457</u>	<u>495</u>
Gross profit		<u>131</u>		<u>153</u>	<u>165</u>
Gross profit percentage		21.8		25.1	25.0
Fuel sales					
	Current year	Previous year		Budget	
	£million	£million	£million	£million	£million
Sales		200		180	210
Cost of sales					
Materials	185		165		185
Direct labour	3		3		3
Direct costs	2		2		3
		<u>190</u>		<u>170</u>	<u>191</u>
Gross profit		<u>10</u>		<u>10</u>	<u>19</u>
Gross profit percentage		5.0		5.6	9.0
New car sales					
	Current year	Previous year		Budget	
	£million	£million	£million	£million	£million
Sales		200		200	220
Cost of sales					
Materials	100		95		110
Direct labour	6		6		5
Direct costs	5		5		5
		<u>111</u>		<u>106</u>	<u>120</u>
Gross profit		<u>89</u>		<u>94</u>	<u>100</u>
Gross profit percentage		44.5		47.0	45.5
Second hand car sales					
	Current year	Previous year		Budget	
	£million	£million	£million	£million	£million
Sales		80		120	100
Cost of sales					
Materials	60		80		75
Direct labour	4		6		5
Direct costs	4		5		4
		<u>68</u>		<u>91</u>	<u>84</u>
Gross profit		<u>12</u>		<u>29</u>	<u>16</u>
Gross profit percentage		15.0		24.2	16.0
Servicing and spares sales					
	Current year	Previous year		Budget	
	£million	£million	£million	£million	£million
Sales		120		110	130
Cost of sales					
Materials	25		20		28
Direct labour	65		60		62
Direct costs	10		10		10
		<u>100</u>		<u>90</u>	<u>100</u>
Gross profit		<u>20</u>		<u>20</u>	<u>30</u>
Gross profit percentage		16.7		18.2	23.1

Figure 2.3 High Street Motors analysis of figures

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EXERCISE 2.5

Why should the net profit percentage be subject to wider variation than the gross profit percentage?

The net profit percentage shows how much of each pound's worth of sales remains as profit after all

expenses. However, tax has to be taken out of this figure and dividends or distributions can only be made out of net profit.

Overheads percentage analysis

As we have seen, the net profit percentage can vary greatly because of the many different overhead expenses. Measuring each overhead expense as a percentage of sales can also be used to indicate possible areas of control. Thus, in Figure 2.2, the comparative overheads percentage analysis would produce:

Overheads	Current year % of sales	Previous year % of sales	Budget % of sales
Property	4	3.3	3.6
Salaries	6	6.2	5.8
Maintenance	2	2.7	2.2
Administration	1	1.3	0.9
Transport	2	2.4	1.6
Marketing	2	2	1.8
Depreciation	2	2	1.8
Interest	3	3.1	2.7
Total overheads	22	23.1	20.5

The reasons for all variations should be explained. These explanations can lead to further examination of individual items making up each category of overheads.

It is not just the unfavourable variations that require explanation.

EXAMPLE 2.1

Within the category of administration costs, the amount spent on insurance shows a favourable comparison to the budgeted figure. This should be examined to consider whether all aspects of the business are adequately insured. The insurance cost could be too low because the business does not have adequate cover. The amount of cover for each risk should be reviewed regularly, and the comparative costs of covering the risks should be reviewed at regular intervals to ensure value for money.

The nature of overheads

The nature of each type of overhead expense should also be borne in mind when seeking explanations of variances. Some expenses, such as advertising or

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marketing, may have a budgeted cap, and the department responsible has a certain budget within which it must work. Any overspend on budgeted items such as this must be carefully investigated, to see if any breach has occurred in internal controls.

Most overheads are fixed by their nature – that is, they are not directly variable in relation to sales.

However, some overheads do have a variable element as well as a fixed element. For example, administrative salaries may well be fixed up to a certain point. However, if there is a large expansion in operations, more administrative staff may be necessary. The same may be true of distribution and transport costs. The salaries of sales staff often include a fixed element of salary, and an element of commission based on sales.

Return on capital employed (ROCE)

This is the net profit (before interest, tax and dividends) expressed as a percentage of the total capital employed in the business. Thus, it includes equity capital and loan capital. This ratio therefore measures the total returns to all suppliers of long-term finance, whether by loans or by equity capital.

In Figure 2.2, the formula is:

$$\frac{\text{Net profit plus interest} \times 100}{\text{Shareholders' capital plus long-term loans}}$$

or:

$$\frac{(p + n) \times 100}{(an + af)}$$

This calculation produces a figure of 23.7% for the current year, compared to 27.7% the previous year, and 31.6% budgeted.

Return on investment

This is sometimes known as 'return on shareholders' funds', and is thus distinct from the ROCE. This is expressed as the percentage of net profit to shareholders' funds.

The definition of net profit is the profit before tax and dividends.

The definition of shareholders' funds is the equity capital plus reserves. Thus, it excludes loan capital, and therefore the result of this calculation is greatly affected by the gearing (see below).

In Figure 2.2, the formula is:

$$\frac{\text{Net profit} \times 100}{\text{Shareholders' capital}}$$

or:

$$\frac{p \times 100}{an}$$

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This calculation produces a figure of 24.7% as the return on shareholders' funds for the current year. However, this has declined from 30.6% the previous year, and the budgeted figure was 33.4%. Clearly some explanation is needed.

The significance of 'return on investment' and 'return on capital employed'

The return on investment, when considered in conjunction with other ratios, such as interest cover and dividend cover, is a key indicator to analysts and investors who might be considering investing in the business. The main point of investing in a business is to earn a regular income from it. The rate of return on the money invested is therefore of vital interest to the general investing public. It is therefore of vital importance to those managing the finances of the business.

Liquidity ratios

Current ratio

This is one of the key ratios in measuring liquidity. Liquidity can be closely allied to working capital, and the management of working capital is discussed in Chapter 5. The current ratio is simply the relationship between current assets and current liabilities. It is normally expressed as the ratio of current assets to current liabilities.

The current ratio calculation will arrive at a figure greater or less than one. If the current assets are greater than the current liabilities, the result will exceed one. If the current liabilities exceed the current assets, the result will be less than one.

In Figure 2.2, the calculation is:

$$\frac{\text{Current assets}}{\text{Current liabilities}}$$

or:

$$\frac{y}{ad}$$

The result of this is 2, meaning that the current assets are double the current liabilities. The previous year's ratio was 1.93. However, it was budgeted to have increased to 2.13.

If this ratio yields a figure of less than one, it might indicate some degree of illiquidity. However, some businesses, such as supermarkets, do manage to operate on a low ratio. This ratio is of the first importance, and trends must be monitored regularly.

Quick ratio

This is sometimes known as the 'acid test' ratio. The stock is excluded from the current assets, and the quick ratio is therefore a measure of the immediately available monies, compared with current liabilities.

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This calculation will always result in a lower figure than the current ratio. However, the important aspect of this ratio is the trend. This ratio also gives a more sharply defined test of liquidity and solvency.

In Figure 2.2, this formula is:

$$\frac{\text{Current assets less stock and work in progress}}{\text{Current liabilities}}$$

or:

$$\frac{y - (u + v)}{ad}$$

The result of this is 1.23, compared to 1.18 the previous year, and a budgeted ratio of 1.23.

Activity ratios

These ratios cover the activities of the business and show the efficiency of the controls in various aspects of the business, such as stock turnover, and credit control.

Debtor days

This measures the debts outstanding on the sales ledger against the annual sales to give a figure showing the number of days' sales which are outstanding at any one point. In Figure 2.2, the calculation (assuming that the whole of the debtors are sales ledger debtors) is:

$$\frac{\text{Sales ledger debtors} \times 365}{\text{Annual sales}}$$

or:

$$\frac{w \times 365}{a}$$

a

The result is 43.8. Thus, at the balance sheet date, there are 44 days' sales outstanding (to the nearest day). The previous year's figure was 45 days, and the budgeted figure was 36 days. This measure only shows the picture at one specific date. To get a better picture, the same calculation could be carried out at different dates, and regularly throughout the year to show trends, and whether the situation is improving or declining.

Creditor days

In a similar way to debtor days, this measures how much credit is being taken from suppliers. This must be calculated from the trade creditors figure (z in Figure 2.2) compared to the total purchase ledger items in the year (which is not shown in Figure 2.2), and multiplied by 365. Although not shown in these accounts, the total purchase ledger items can be calculated by addition of the

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monthly totals in the purchase day book. Once again, this only shows the position at a specific date. The same calculation could also be carried out at different dates, and regularly throughout the year.

Trends are important, and a lengthening trend could show that the business is starting to exceed its normal authorised trade terms with its suppliers. If this were allowed to continue, it could endanger working relationships with suppliers, and lead to shortages of vital supplies. The whole production cycle could be disrupted, with a serious effect on the viability of the business.

Stock turnover

This measures the number of times that stock is turned over during the year. It is measured by dividing the cost of materials used by the closing stock and work in progress figure. In Figure 2.2, this calculation is:

Cost of materials

Stock and work in progress

or:

$$\frac{b}{u + v}$$

The result of this calculation is 3 times in the current year, 2.7 times in the previous year, and budgeted 2.7 times. In general, the higher the stock turnover figure, the better the stock control procedures.

This method is sometimes refined if the level of stock varies greatly during the year. The refinement is to use the average level of stock carried throughout the year, as the basis of comparison. This can be found by averaging out the opening stock and work in progress and the closing stock and work in progress. Thus, in Figure 2.2, the figure to use would be the average of the previous year's figures and the current year's figures, which gives 47 million instead of 50 million. This yields a stock turnover figure of 3.2 times.

If the stock records give monthly stock and work in progress figures, it is also possible to use the average of the twelve months' figures, to give an even more accurate stock turnover. This exercise can then be carried out on a 'rolling year' basis. This means that, every month, the average figure used is that of the preceding twelve months, and the stock turnover is calculated on the cost of materials over the previous twelve months.

Any adverse trends in this figure (i.e. if the stock turnover trend is decreasing) could point to dangers of stock deterioration, wastage, pilferage, or obsolescence.

There can be no absolute guide to ideal stock turnover figures. The figures vary greatly from one business to another. Manufacturing businesses, for example, generally turn stock over more slowly than retail businesses. Even different types of retail business turn stock over at different rates. Fashion retailers for instance would carry larger volumes of stock than fast food outlets or fresh food retailers.

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Asset turnover

This is a calculation, or rather a series of calculations, to show how much sales are generated by the assets in use. Thus, the asset figures used can be the fixed assets, the total gross assets, or the net assets. Once again, these figures are best seen as comparisons with previous periods, to recognise trends. In general, they point to the efficiency of asset management and use.

Fixed asset turnover

In Figure 2.2, the fixed asset turnover can be calculated by the formula:

Turnover

Total fixed assets

or:

$$\frac{a}{t}$$

This shows £500 million of turnover generated by £400 million of fixed assets – a ratio of 1.25, compared to 1.28 the previous year, and compared to the budgeted figure of 1.41. This means that every £1 of fixed assets generates £1.25 of sales for the current year, £1.28 of sales the previous year, and £1.41 of budgeted sales. This can be broken down further, and the turnover applied to different types of fixed assets.

The comparisons for fixed asset turnover can be distorted when there is significant investment in new assets in a year.

Gross asset turnover

In Figure 2.2, the gross asset turnover can be calculated by the formula:

$$\frac{\text{Turnover}}{\text{Total fixed assets plus total current assets}}$$

or:

$$\frac{a}{t + y}$$

This gives a ratio of 0.95, compared to 0.97 the previous year, and a budget of 1.06.

Net asset turnover

In Figure 2.2, the net asset turnover can be calculated by the formula:

$$\frac{\text{Turnover}}{\text{Net assets}}$$

or:

$$\frac{a}{ag}$$

This shows a ratio of 1.30 the current year, 1.40 the previous year, and a budget of 1.41.

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Capital ratios

Total liabilities to total assets

An important figure in the balance sheet is the net assets (ag in Figure 2.2). This gives the actual figure represented by the shareholders' funds. The details show how it is split between assets and liabilities, and the breakdown between long-term assets and liabilities and short-term assets and liabilities.

Another useful index is the ratio between total liabilities and total assets. In Figure 2.2, this is calculated by the formula:

$$\frac{\text{Current liabilities plus long-term liabilities}}{\text{Fixed assets plus current assets}}$$

or:

$$\frac{ad + af}{t + y}$$

In the example, the ratio is 0.27, compared to 0.31 the previous year, and a budget of 0.25.

This can also be broken down to the short-term and long-term ratios of liabilities against assets. This is calculated for short-term figures by:

$$\frac{\text{Current liabilities}}{\text{Current assets}}$$

or:

$$\frac{ad}{y}$$

and for long-term figures by:

$$\frac{\text{Long-term liabilities}}{\text{Fixed assets}}$$

or:

$$\frac{af}{t}$$

The short-term ratio figure is therefore 0.5 for the current year and 0.5 for the previous year, with a budget figure of 0.47. (This is the reverse of the current ratio above). The long-term figure is 0.2 for the current year, 0.24 for the previous year, and 0.18 budgeted.

Gearing

Gearing represents the relationship of loan capital to total capital. If a company has long-term loans of £800,000, and equity capital of £200,000, the total capital is £1,000,000. The percentage of loans to total capital is 80%. In general terms, anything above 50% is considered a high gearing, although each case must be considered on its own merit.

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In Figure 2.2, the calculation is:

$$\frac{\text{Long-term liabilities} \times 100}{\text{Long-term liabilities plus shareholders' funds}}$$

or:

$$\frac{\text{af} \times 100}{\text{af} + \text{an}}$$

This calculation reveals a gearing of 18%.

Gearing is considered in further detail in Chapter 10, where it will be seen that high gearing is more risky for equity investors. A crucial factor in a high-gear company is interest cover.

Interest cover

This is a particular measure of one specific item of overhead – interest paid on loans. It shows how the interest paid relates to the profit. In Figure 2.2, the calculation is:

$$\frac{\text{Net profit}}{\text{Interest}}$$

or:

$$\frac{\text{p}}{\text{n}}$$

This calculation shows interest cover of 6 times, compared to 6.8 times the previous year, and a budgeted figure of 8.5 times.

This figure becomes significant if profits drop. If a business has a low interest cover, any drop in profits means that after interest is paid, the amount available for distribution as dividends is much lower. This is more pronounced in businesses which are highly geared.

Performance measures for non-profit organisations

The methods described above relate primarily to businesses which exist to make profits. Non-profit organisations (NPOs), such as charities, public bodies, housing associations, schools, hospitals, and so on, have different objects, and need different performance measures.

These organisations are no less accountable than businesses, although they are accountable to different people.

EXERCISE 2.6

What measures do you think are appropriate to NPOs?

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NPOs must develop their own performance measures, to reflect their own missions or purposes. There are four steps to developing performance measures:

Identify clearly and precisely the organisation's purpose and aims.

Find quantitative, measurable indicators. (Remember, if you can measure it, you can control it.)

Develop the indicators. This involves managers from the organisation identifying and developing indicators which are relevant to the purpose, and effectively measure the achievement of the purpose and aims.

Implement the measurement system. This impacts on reporting systems, and evaluation of the results. Once up and running, the system is likely to go through refinements and changes.

Various schemes have been implemented to measure performance. Exhibits 2.1 and 2.2 describe two.

Exhibit 2.1

The four-pronged measure

Input measures. These quantify the level of inputs into projects or aims. These inputs can be financial and non-financial (for example, the time put into them).

Output measures. These measure the outputs, and are more frequently in non-financial terms. Thus, a university may measure its outputs by the number of students who graduate in a particular year, or a shelter for the homeless may measure the number of people housed.

Outcome measures. These measure how well aims have been met, and they are also largely non-financial. For instance, a project in a third world country to teach adults to read may measure its outcome by the increasing (or otherwise) trend in literacy rates over a period of time.

Efficiency measures. These compare the input measures with the output and the outcome measures to gauge the efficiency of the organisation in achieving its aims.

Exhibit 2.2

At-a-Glance

This scheme was developed by a financial manager of a Registered Social Landlord (previously known as a Housing Association). The purpose is to present in one easy to grasp chart, measures to monitor the performance of the organisation compared to the aims of the governing body.

The governing body is the Housing Corporation, which lists three aims for Registered Social Landlords:

The organisation should be properly managed.
The organisation should be financially viable.
The organisation should be properly governed.

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A series of ten measurement criteria were developed using the four steps outlined above. Several of these involved non-financial measurements, for which appropriate measurements had to be refined. These measures related to the three aims, as follows:

- Proper management
- Tenant satisfaction
- Voids and letting performance
- Rent arrears
- Maintenance response
- Staff sickness
- Staff turnover
- Viability
- Budget control
- Cash management
- Loan covenants
- Governance
- Various governance criteria

The monthly results of these measures are displayed graphically by a 'radar' chart (see Figure 2.4), divided into red, amber, and green areas. The red area is nearest the middle (a 'bull's eye'), then amber and the green ring is the outer area. Divisions are roughly one-third each. These areas denoted the degree of achievement – the red area denoting the greatest need for corrective action.

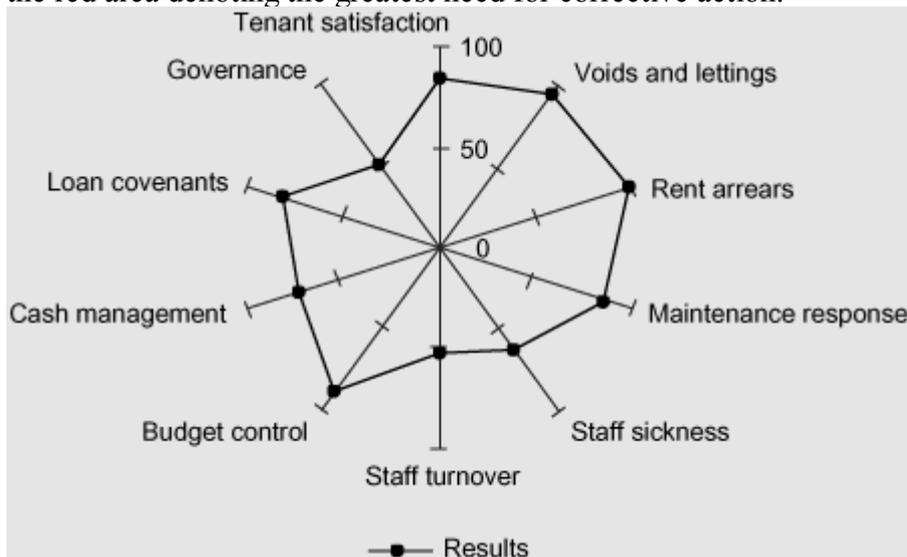


Figure 2.4 At-a-Glance chart

Now, management and the board can readily grasp what action is needed on a regular basis.

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Difficulties in achieving performance measures

In practice, achieving relevant performance measures is more difficult for NPOs than for commercial businesses for the reasons given below.

Non-financial measures

A typical factor in non-profit organisations is that performance measures include much non-financial data. In practice, this requires ingenuity to devise a system of measuring things which are often intangible – such as the satisfaction of end receivers of the organisation's activities. Inevitably, these measures have to be constantly refined as they are used.

Difficulties of identification

Difficulties arise from the problem of identifying the roles. Who, for instance, owns the organisation? And who is the 'customer'?

Management attitudes

When managing non-profit organisations, it is easy to adopt extreme risk aversion and other attitudes which inhibit the implementation of new ideas. 'Commercial' attitudes can be considered inappropriate to the organisation, and the development of new performance measures is inhibited.

Additionally, members of the governing boards must be encouraged to adopt an incisive, questioning attitude which ensures that standards are not allowed to slip.

Summary

Financial accounts, cost accounts and management accounts are the raw material of financial control and management. Understanding them is a key to the effective management of the finances of any organisation. The figures in the accounts reflect what is actually going on in an organisation. An informed reader of accounts can gain insights into how the organisation works, where its shortcomings lie, how its results have been affected by changes in policy, changes in circumstances, and many other areas.

Here is a key principle:

► Figures in accounts are not just numbers on a piece of paper. They represent something substantive – something that has happened in the real world. Discovering what they mean is a vital tool in exercising financial control.

Therefore, understanding financial statements is an indispensable tool in financial management. However, it is not enough simply to look at the accounts and understand what they mean. Understanding must be followed by action, and that action is the essence of financial management.

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Experience is also important in exercising control. When financial directors or managers have been working in the same business for some time, experience of the business will enable them to spot trends or anomalies in the figures – it becomes a kind of instinct.

EXAMPLE 2.2

An analysis of the activity ratios may show that the quick ratio has been steady for the last six months. In itself, this may appear satisfactory.

However, over the same period, the debtor days have increased, from 36 days six months ago to 39 days at present.

This could indicate that something is slipping in the sales ledger department – perhaps the control procedures are becoming more lax.

Procedures should be reviewed. Are they being applied consistently? Have there been staff changes in the sales ledger department which affect the credit control procedures? Are new customers being accepted without the proper controls?

An examination of the aged debtors lists for each month may show specific problems. Do the figures show a gradual increase month by month, or is there a sudden increase in one month, which should be examined more carefully?

Is any particular debtor or group of debtors showing delinquent behaviour, such as unauthorised extensions of their credit period? If so, has anyone contacted them? Are current orders on hold while the problem is sorted out?

However, even the most experienced financial managers can often overlook problems or solutions which another, less experienced, person may suggest. Therefore, it is vital to remain open to any and all suggestions. Very often, something pointed out by a person from a different department can also enlighten a problem and lead to a successful course of action. Financial managers must be prepared to listen to non-financial managers, and other employees lower down the line.

ASSIGNMENT

The financial statements of O.T.T. Ltd (a privately owned company), are summarised in Figure 2.5.

Comment on what these figures suggest, and what action or enquiries you would make after examining them.

SUGGESTIONS

Profit ratios

The turnover has increased by over 28% – a significant increase. Further, the gross profit rate has increased from 40% to just over 42%. The net profit has increased by over 60%, and the net profit rate has increased from 18.8% to 23.5%. The return on capital has increased from 58% to 76%.

These indicators would appear to indicate a healthy state of affairs.

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Profit and loss account

	Current year		Previous year	
	£000	£000	£000	£000
Turnover		4,500		3,500
Cost of sales				
Materials	1,800		1,500	
Direct labour	500		400	
Factory costs	300		200	
		<u>2,600</u>		<u>2,100</u>
Gross profit		1,900		1,400
Other income		10		5
		<u>1,910</u>		<u>1,405</u>
Overheads				
Property	100		90	
Salaries	150		120	
Maintenance and repairs	75		60	
Administration	35		32	
Transport	80		63	
Marketing	80		40	
Depreciation	80		100	
Interest	250		240	
Total overheads		<u>850</u>		<u>745</u>
Net profit		1,060		660
Taxation	210		130	
Dividends	600		200	
		<u>810</u>		<u>330</u>
Retained profit		<u>250</u>		<u>330</u>
Balance sheet				
Fixed assets		1,200		1,250
Current assets				
Stock	600		400	
Work in progress	60		30	
Debtors	1,500		800	
Bank and cash	5		50	
		<u>2,165</u>		<u>1,280</u>
Current liabilities				
Trade creditors	800		400	
Other creditors	120		50	
Dividends and tax	310		150	
Bank overdraft	600		0	
		<u>1,830</u>		<u>600</u>
Working capital		335		680
		<u>1,535</u>		<u>1,930</u>
Long-term liabilities		155		800
Net assets		<u>1,380</u>		<u>1,130</u>
Represented by:				
Capital				
Ordinary shares		1,000		1,000
Profit and loss account		380		130
		<u>1,380</u>		<u>1,130</u>

Figure 2.5 O.T.T. Ltd: Financial statements for the year ended 31st December 20xx
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However, the overheads should be examined in more detail, and the following questions asked:

While turnover has increased by over 28%, overheads have only increased by 14%. Is the infrastructure of the company keeping pace with the rapid growth of turnover?

As the company is a privately owned company, how much are the owners taking out of the company, as directors' salaries and as dividends? The salaries increased by £30,000, and the dividends increased by £400,000. Are the owners, in their capacities as directors and shareholders, taking too much money out of the company, given the need of the company to retain cash to finance its rapid growth?

The administration costs only increased by £3,000 over the previous year, when the turnover had increased by £1 million. Does this indicate that the administration of the company will be struggling to keep up with