Finance for non-financial managers

Whatever your area of expertise, you need to understand the basics of financial management. This will give you an informed view about the company's performance, and allow you to play a full role in shaping its strategy.

This briefing discusses:

- Profit and loss accounting.
- The balance sheet.
- Cashflow.
- Measuring profitability.
- Budgeting.

1 Profit and loss

Profit is essential in the longer term. Without profits, you will need to continually raise additional financing (or sell assets) to keep trading.

1.1 The profit and loss statement provides a picture of the company's **trading performance** over the last 'accounting period' (usually a year).

The profit and loss statement records sales, costs and expenses, profits (and losses), and any tax provisions for the period, even if they have not yet been paid.
For example:

- Sales and purchases are recorded when the sale or purchase is invoiced.
- The costs of fixed assets (eg vehicles) are spread over their useful working lives. Rather than charging the full cost when the asset is purchased, an annual 'depreciation' charge is made instead. (See box, page 2).
- Prepayments (eg rent in advance) and accruals (eg interest payable later) are matched to the period they relate to.

  Transactions which do not directly affect profits are not included. For example, financing activities (eg taking out a new loan) are not included, but interest payments and bank charges are.

1.2 The statement usually follows a relatively simple **format**.

- Turnover (or sales), excluding VAT.
- Cost of sales.
  This represents 'direct' costs, such as raw materials. These costs usually rise in line with the volume of sales.
- Gross profit (turnover less cost of sales).
- 'Indirect' costs (or overheads) such as

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rent, rates and salaries. This will include depreciation on fixed assets (see box).
- Operating profit or profit before interest and tax (PBIT).
  PBIT also includes non-operating income and costs (eg if you sell an asset).
- Net interest payable (eg on bank loans).
- Profit before tax (ie after deducting interest charges from PBIT).
- Tax payable.
- Net profit.

1.3 You may need to ask **questions** to get a clear understanding of what the profit and loss statement is telling you. The profit and loss statement reflects an element of judgement.

Depreciation

A Depreciation simply spreads the cost of **fixed assets** over their working life.

For example, a £30,000 computer system which lasts for three years could be said to cost you £10,000 per year. Without depreciation, you would have to:

- Charge the full £30,000 against profits in the year you purchase the system.
  This would give unrealistically low profits for that year.
- Charge nothing against profits for the remainder of the computer system's life.
  This would give unrealistically high profits for these later years.

B Your accountant will give you guidance on what depreciation **rates** to use.

The key decision is how quickly to depreciate an asset. For example, you might choose to charge:

- 33 per cent of the cost of a computer system against profits over three years.
- Two per cent of the balance sheet value of a building you own against profits each year.

C Occasionally, depreciation may lead to **unrealistic** profits or losses and an unrealistic balance sheet.

- For example, if an asset becomes obsolete before you expected it to, it will lead to an additional charge on profits.
  Your accountant can make one-off adjustments to correct this.

For example:

- How much of the income from a long-term contract (eg five years) should be included in that year's profit.
- What adjustments to make for customers who are unlikely to pay.
- How quickly to depreciate fixed assets.

  The choices made will also affect the balance sheet (see **2.3**).

2 The balance sheet

The balance sheet gives you a picture of the company's financial strength at the end of the accounting period.

2.1 The balance sheet summarises **assets** (what you own) and **liabilities** (what you owe).

- Fixed assets (eg plant and machinery).
  Fixed assets are shown at their depreciated values. These include intangible assets such as licences and intellectual property rights.
- Current assets (short-term assets).
  This includes stock and work in progress inventory, debtors (customers who owe you money) and cash.
- Current liabilities (amounts you owe which are due for payment within one year).
  For example, trade creditors (suppliers you owe money to), bank overdraft and hire purchase.
- Long-term liabilities (creditors due after more than one year).
  For example, bank and directors' loans.
- Shareholder funds.
  This includes share capital (ie amounts paid into the company for shares) and reserves (including retained profit).

2.2 The total financing for the business is called **capital employed**.

Capital employed equals long-term financing (eg bank loans) plus shareholder funds.

- The figure for capital employed will always equal fixed assets, plus current assets, less current liabilities.

2.3 You may need to ask **questions** to get a clear understanding of what the balance sheet is telling you.

Like the profit and loss statement, the balance sheet reflects an element of judgement. For example:

- How quickly to depreciate fixed assets.

- How to value intangible assets (eg licences, where a value could be attributed but its validity would depend on the state of the market when the licence was sold).
- How to value stock and work in progress.
- What adjustments to make for customers who are unlikely to pay.

The choices made will also affect the profit and loss statement (see **1.3**).

The profit and loss account and balance sheet form part of your statutory accounts for Companies House. Alongside information about the firm's cashflow, profitability and budget they can also be useful when making management decisions.

3 Cashflow

Cashflow is the short-term priority for every business. If you run out of cash (and cannot raise additional finance), the company will be insolvent.

3.1 The cashflow statement shows what has happened to your **cash** position over the accounting period.

- 'Cash' includes money in the bank.

3.2 The cashflow statement differs from the profit and loss statement because it shows the **timing** of payments and receipts.

It can be prepared by adjusting the profit and loss statement for 'non-cash' items. Typically, these include:

- Depreciation (see box, page 2).
- Changes in debtors and creditors.
  For example, if the amount you are owed for sales has increased, your cash position will be reduced.
- Financing activities (eg new loans).

3.3 The cashflow statement can look complicated but carries a **simple** message.

It tells you whether your business is generating cash or using it up.

- A mature, profitable business will usually be cash generative.
- A younger, growing business may be using up cash even if it is profitable. The business may need to raise additional finance to keep growing.

4 Measuring profitability

4.1 Your **profit margins** can be calculated from the profit and loss statement (see **1.2**).

- The gross profit margin is gross profit as a percentage of turnover.
  For example, if your turnover is £200,000 with a cost of sales of £60,000, you have a gross profit of £140,000 and a gross profit margin of 70 per cent.
- The operating (or net) profit margin compares operating profit (ie after taking account of indirect cost) to turnover.
  For example, turnover of £200,000 and operating profit of £30,000, the operating profit margin would be 15 per cent.

4.2 You can **compare** profit margins to get a clearer picture of your performance.

- Compare profit margins to other companies to highlight where you are doing well and where you should improve.
- Compare profit margins to previous periods to see where your selling prices are coming under pressure or costs are increasing.
- Compare profit margins on individual product lines to see which products are the most profitable.
  Although the formal profit and loss statement will not give this level of detail, your internal management accounts should.

4.3 Profit margins tell you how much room for manoeuvre you have on **pricing** and what sales you need to break even.

- As long as you have a positive gross margin, each sale will make some contribution to covering your overheads.
- Dividing your total overheads by your gross margin tells you what sales you need in order to break even.
  For example, with overheads of £50,000 and a gross margin of 25 per cent, you will reach break even with turnover of £200,000 (ie £50,000 ÷ 25 x 100).
- If you decrease your margins (eg by reducing prices), you will need to increase sales to maintain the same profits.

4.4 Comparing profits to **assets** also provides a measure of profitability.

- Return on capital employed is PBIT as a percentage of capital employed.
  This shows what return you are making on the money financing the business (both as loans and shares).
- Return on equity is profit before tax (but after interest has been deducted) as a percentage of shareholders funds.

These percentages can also be compared

to the same figures for other companies as an indication of how effectively your business is using the money invested in it.

4.5 Some businesses will find **other measures** of profitability more appropriate.

For example:

- A retail business might focus on profits per square foot of shop space.

4.6 You (or your accountant) can also use your accounts to get further information on your **financial position**.

Areas which businesses focus on include:

- Growth.
  For example, comparing sales from one period to the next.
- Financial strength.
  For example, looking at how large a proportion of your financing is borrowed, and how well you could cope if business conditions became difficult.
- Control of working capital (ie current assets less current liabilities). For example, how much money you have tied up as stock, how efficient you are at collecting debts, and how quickly you pay suppliers.

As with the measures of profitability, comparing key ratios to other businesses, and against the same figures for previous periods, helps to highlight areas where you need to take action.

5 Budgeting

Annual financial statements are not enough to control your business. You also need to forecast what will happen, and to have up-to-date information on recent performance.

5.1 Prepare budgets to set financial **targets** and to determine financing requirements.

- You must produce a cashflow forecast.
  It is good practice to produce profit and balance sheet forecasts as well.
- Detailed budgets (eg sales and costs broken down for each product) allow you to see where your profits and cashflow are coming from.
- Your cashflow budget enables you to anticipate any financing requirements.

5.2 Create **realistic** budgets.

- While the previous year's figures provide a guide, forecasts must also take into account changes (eg new competition).
- Forecast monthly (or weekly) figures which take account of seasonal variations.
- Include timing effects (eg if customers pay 60 days after purchasing).
- Calculate a range of forecasts and the probability of achieving them.
- Computers can make budgeting and investigating what-if scenarios easier.
  For example, what the effect will be if your sales are ten per cent lower than forecast.

5.3 Compare **actual** performance against budgets to identify problems (and opportunities).

- Record actual outcomes and compare them to budgeted figures.
  It is easiest to see how significant the variances (ie differences) are if they are expressed as percentages.
- Identify the broad cause of the variance.
  This will be a different volume (eg sales of 1,100 against 1,000 budgeted), a different price or a combination of both.
- Regularly update budgets to take account of actual performance.

5.4 Be aware of real world **problems**.

- Imposing a budget (eg demanding cost cuts of ten per cent) often fails.
  Managers and employees are more likely to meet targets they have agreed.
- Budgets can build in assumptions rather than questioning them.
- Aggressively controlling performance against budgets can lead to managers setting comfortable budgets. These represent targets which are easy to meet, so that no one pushes themselves.
- Avoid setting over-ambitious and unrealistic budgets.

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