EYB

وسّع أعمالك

Expand Your Business

An Integrated Support Program For Growth Oriented Enterprises

Strategic Financial Management

Increase Your Profits

INTERNATIONAL LABOUR ORGANIZATION

USAID

UNDP

EYB

وسّعْ أعمالك

Expand Your Business

An Integrated Support Programme for Growth Oriented Enterprises

STRATEGIC FINANCIAL MANAGEMENT

JORDANIAN EDITION

Written by Peter Blanchard Etal

Adapted by Mahmoud Al-Sayyed

International Labour Organization

The American Chamber of Commerce in Jordan

Am Cham - Jordan

USAID

UNDP

حزمة الأمان الاجتماعي

Social Productivity Program

برنامج تنمية المشاريع الصغيرة

SME Development Program

About Expand Your Business (EYB)

EYB stands for Expand Your Business. It is an integrated business training and support programme for small to medium scale enterprises that have growth potential and capacity to create more and better jobs.

The vision of the EYB Programme is to assist growth oriented enterprises that have growth potential to develop effective strategies to exploit the growth potential of their enterprises. They are also assisted to strengthen their business functional areas in marketing, human resources and finance.

The EYB Programme is targeted towards Growth Oriented Enterprises (GOEs) that have a growth potential, employ between 6 to 100 employees, have basic management systems and have been in operation for at least one year. The EYB Programme is designed to enhance the knowledge and skills of Owners, Executive Directors, General Managers and functional managers in marketing, human resources and finance. The programme is designed to assist the GOEs to anticipate, plan and successfully manage the growth of their enterprises.

The EYB is an integrated programme, which involves classroom training, facilitation of business and financial linkages, individual counselling sessions and facilitation of Business Support Groups. The individual counselling sessions assist GOEs to complete their Business Growth Plans. The Business Support Groups provide an opportunity for GOEs to meet and discuss common problems, challenges and solutions, network and receive expert advice from invited resource specialists in identified areas.

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Contents of this module ...

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YOU

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EXPAND YOUR BUSINESS

EYB

Training Modules

START HERE

Strategic Management

Strategic Marketing Management

Strategic Human Resources Management

Strategic Financial Management

In this module, you will find:

■ Relevant business knowledge and information

Read the simple theory and information relevant to the topic of this manual. The examples on the case study that follow the theory and information show how knowledge is utilised to manage a business well.

■ Practical exercises

Do the exercises in the module and then compare your answers with the suggested answers given at the end of the module to find out how much you have learnt.

■ Action and Growth Plans

Fill in and use the action and growth plans. This will help you to put your new knowledge into practice.

■ Useful business terms

Useful business terms are denoted in ***bold italics*** when they used for the first time in the module. Look up the meaning of these terms in the text box next to them. Memorise their meanings they can also located in the glossary section of this module.

■ The symbols

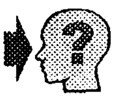
You will see the following symbols in the left hand margin. The symbols indicate the nature of the text contained in the boxes next to them as explained below.

Next to this symbol, you will find the objectives of the module and its chapters.

Next to this symbol, you will find exercises for you to do or questions for you to answer.

The box next to this symbol gives you suggested answers to an exercise in the manual. Remember to work out your own answers before you read the answers in the module.

The box next to this symbol tells you where to find more information in the other modules or elsewhere, for example: **EYB Module: Strategic Financial Management** tells you more about how to interpret financial ratios.



The box next to this symbol asks you questions about your own business.

The box next to this symbol tells you something, which is extra important for you to memorize. For example, **the customer is the most important person for your business.**

The box next to this symbol provides you with examples on the case study used in this module. It shows the use of theory and information in context in the case study.

PREFACE

1. About the Strategic Financial Management module...

In this Financial Management Module, we will discuss a practical system to manage your company's finances in terms of both controlling the assets of the business, and measuring the success of the business in financial terms.

The outputs of this module include:

- Development of financial management systems,
- Knowledge and skills to develop, analyse, and interpret financial statements:
  - Income statement,
  - Balance sheet,
  - Cash flow statement,
- Development and control of financial plans,
- Analyses of capital investments,
- Working capital management policy,
- Sources of finance analysis,
- Strategy for safeguarding business resources,
- Establishment of financial growth plans.

The underpinning philosophy of this module is that financial management is becoming an essential for those enterprises that intend to grow in an increasingly competitive and global business environment. This philosophy applies to small and medium size enterprises, as much as it applies to multinational/global corporations.

The primary focus of this module is typically to outline the various aspects of financial management necessary for growth -oriented enterprises (**GOEs**). To progress through this module no prior knowledge of financial management other than personal experience is required.

2. Whom this module is for...

This manual is for YOU if you are managing a business, and is willing and planning to expand it, and improve its performance and financial results. It is for you if your business is currently employing between 6 and 100 employees, and having good market opportunities, good human resources, and product or products with a good position in the product life cycle (i.e. with a growing market share and volume).

This Module is for you if you are holding one of the following posts in the business:

- **The General Manager, CEO or Managing Director.**
- **The financial manager, or one holding a similar position or responsibilities**

This Module is for you if you have acquired the basic business management systems in marketing, record keeping, costing, buying, stock control and business planning basics.

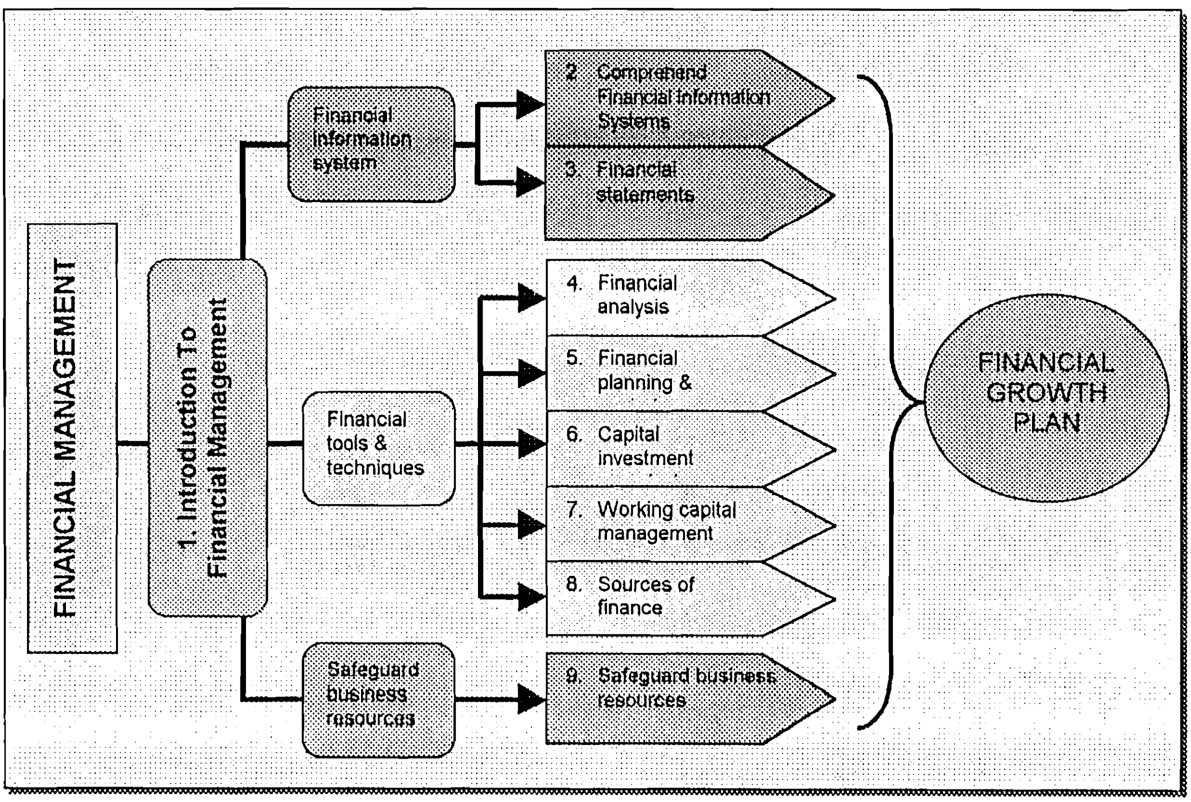
3. How this module is presented...

This module comes in a nine -chapter format, each relating to a particular key element of financial management. The emphasis is very much on practical application of financial management supported by examples and exercises.

At the end of each chapter, there is an **action plan**, which you should complete section-by-section after you have covered the relevant chapter.

The **following flow chart** illustrates the module framework that indicates the interrelation between different chapters and parts. The chart consists of nine chapters that aim at assisting you to understand your financial performance, and manage your business finance.

The chart shows you how this Financial Management Module has been organised and how it will lead you to prepare your financial growth plan.



Chapter One is an introduction to the Financial Management that aims to enhance your appreciation of financial management.

Chapter Two helps you understand the basic financial management information system in your business including, record-keeping systems and computerised accounting systems.

Chapter Three helps you understand the basic financial statements of a business: Income Statement, Cash Flow Statement and the Balance Sheet. These represent the outcomes of your financial information system.

Chapter Four focuses on financial analysis tools and techniques that will help you to evaluate the growth of your business, and provide you with new angles of the understanding of financial statements. This will cover trend analysis, common size analysis and ratio analysis.

Chapter Five provides specific tools to help you budget and control the finances of your business. These budgets help you to plan the allocation, and use of the financial resources that are used to implement your business expansion strategy. They will, also help you to stay on track, and to recognise and correct problems before they become serious.

Chapter Six provides tools to help you evaluate investment decisions like, "Which is a better machine to buy? Alternatively, should I lease my next truck or buy it? As you implement your expansion strategy, these will be important decisions you need to make.

Chapter Seven focuses on how to manage your working capital. As you implement your expansion plan, your business will require large amounts of money to fund inventory, payroll, operating expenses and debtors' accounts. The tools presented in chapter six will help you to manage your working capital, and ensure that you have sufficient funds to grow.

Chapter Eight focuses on how to obtain capital to finance the short and long-term needs of your business as it grows. All businesses owners feel that financing in the most challenging aspect of the business. This chapter gives specific tools to make that job more manageable.

Chapter Nine of this module focuses on safeguarding your business assets, and provides you with some techniques to protect your business from a disastrous loss. Your business maybe your single largest financial investment, and is probably the main source of income for you and your family. Natural disasters, robbery and theft can cause very serious problems, and it is important that you take measures to minimize this risk.

Chapter Ten that contains the **Financial Management Growth Plan** will provide you with tools and forms to develop your financial growth plan which provides you with a map to implement and monitor the financial performance of your business through the growth process.

4. Before you read this module,

The Strategic Financial Management is a fundamental module in the Expand Your Business (**EYB**) Programme. You will benefit more from the **EYB** programme if you read the **EYB** modules:

- **Strategic Management**
- **Strategic Marketing Management**
- **Strategic Human Resources Management**

5. What you will learn in this module ...

If you aim to grow your business, this module will be of great help to you. The basic idea of this module is to help manage your business finance for growth. First, you should get ready for growth, then you need to plan your growth, and then you should organise your enterprise to grow. This Module seeks to enhance your understanding of financial management, and the tools you will need to deal properly with your finance.

After studying this module, and completing the exercises in it, and with the guidance of your business trainer, you will be able to:

- **Explain the importance of sound financial record keeping systems.**
- **Develop and automate your financial management system in line with the growth plan.**
- **Analyse and interpret the financial performance, the financial position and the cash flows as shown in the income statement, balance sheet and cash flow statements respectively.**
- **Use the "capital investment appraisal" techniques to evaluate expansion options.**
- **Develop effective working capital management systems.**
- **Develop better access to sources of capital for your growing business, and design your capital structure.**
- **Develop effective control systems for safeguarding your business.**
- **Develop a financial plan for your business to achieve growth.**

Financial management enables you: **to measure** the performance of your business, provide you with the **necessary information** for taking **corrective action** when necessary. It will, also help you to track your business to achieve your ultimate business goals. Financial management provides you with the information to support decisions, and to forecast and plan **your business.**

The financial management function cannot exist in isolation. It is *closely- linked* to the overall strategy and the goals of your business that you set up earlier. It also closely links with your marketing and human resource management strategies.

Financial management totally depends on the cost and revenue information of your marketing, human resources and production functions.

The marketing management strategies and human resources management strategies to choose from for growth-oriented entrepreneurs (GOEs) are discussed earlier in detail in separate EYB modules on Strategic Marketing Management, and Strategic Human Resources Management.

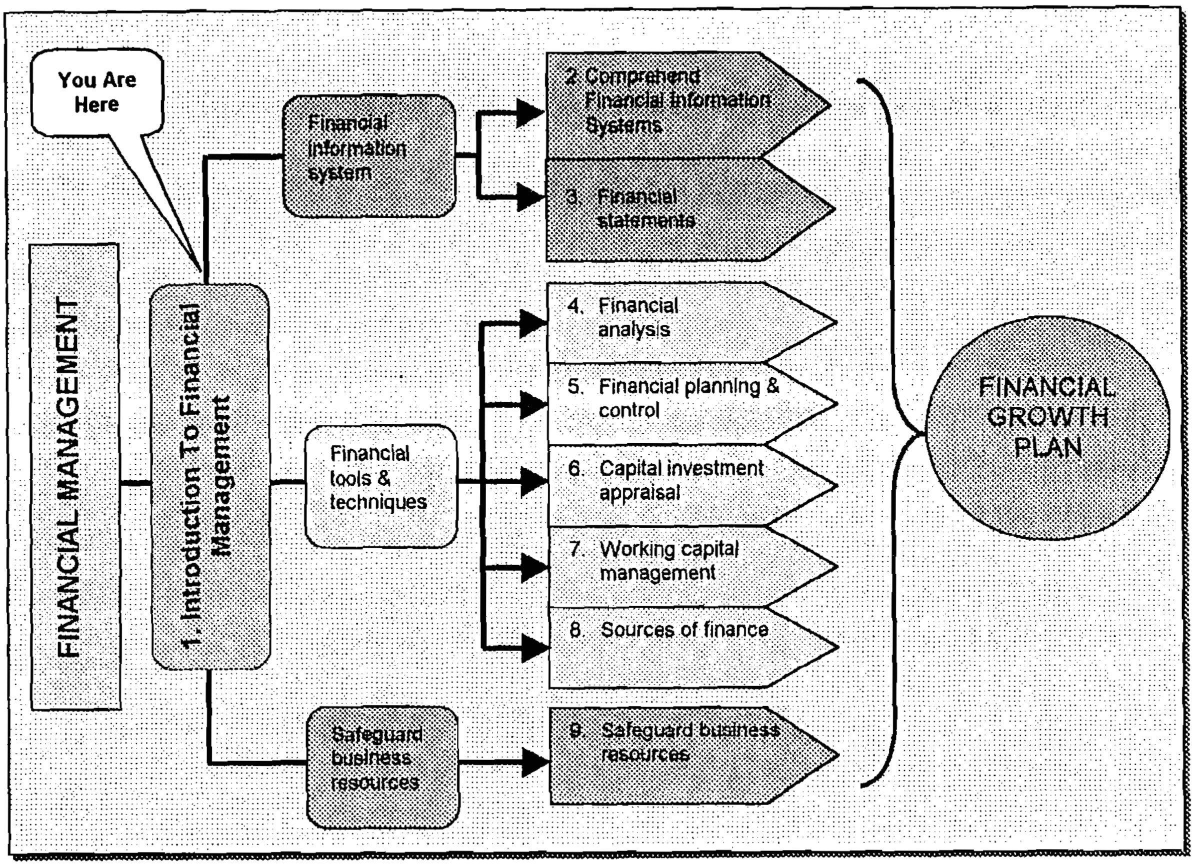
Chapter
1

APPRECIATE THE ROLE OF FINANCIAL MANAGEMENT

What you will learn in this chapter ...

After studying this chapter, and completing the exercises in it, and with the guidance of your business trainer, you will be able to:

- **Define financial management.**
- **Explain the role and importance of financial management.**
- **Explain how financial management can help you expand your business.**
- **Explain the cash flow cycle in your business.**



1. What is Financial Management?

Financial management is the business management function that is concerned with managing a business's finances. It refers to the application of financial management tools and techniques to coordinate all financial functions in the business enterprise. This involves:

> ***Financial management*** is the business management function that monitors, controls and allocates the vital resources of a business. It plays a key role in the formation of the primary business strategies and the achievement of key business objectives.

- **Setting financial objectives.**
- **Financial analysis, planning, and control.**
- **Management of the acquisition and application of funds.**

Financial management is not just concerned about proper financial record keeping and the production, analysis and interpretation of financial statements. It is, also concerned about the control of your business resources, preventing theft and losses, and making decisions about investment.

Financial management is central to the success of the business; it helps you to manage the key resources of the business.

Financial management cannot operate in isolation. It must operate in relation to the other key business management functions. Financial management depends on information that is provided in a timely manner from the various business management functions, including marketing, production and human resources.

You must find a way to integrate your financial management function with the other functional elements of the business. This is via the strategic management process.

■ Setting Financial Objectives

Setting objectives is an important aspect of success in life. The most successful people in the world state that a major reason for their success is the ability to set and achieve specific objectives. The same is true for a business, and the most successful businesses are goal oriented.

A business should provide business owners with a satisfactory return on their investment whilst, at the same time, meeting the aspirations of other stakeholders such as employees, lenders, creditors and customers. Principal among the financial objectives of an enterprise are its short, medium and long-term profitability objectives. **These should be defined in very specific concrete terms.**

■ Financial analysis, planning, reporting and control.

The financial management function uses financial statements generated by the financial accounting system to analyse the financial performance, position and cash flows of the business. Based on this analysis and projections for the future, financial decisions and plans are made. As the business operates and prepares records on its financial results and position, the financial plans are compared with these reports, and where necessary control action is taken.

■ Management of acquisition and application of funds.

Financial management is also concerned with planning and acquiring the optimum finances required to meet the business's objectives and seeing that funds are employed efficiently and effectively. This may involve the proper control of business resources, preventing theft and losses, and making decisions about investment.

Financial management may utilise information from the financial accounting system. Financial accounting is concerned with proper financial record keeping and the production, analysis and interpretation of financial statements.

2. Importance of Financial Management

When you first started your business, you probably never thought that you would be dealing with income statements, balance sheets, cash flow statements and similar financial statements. Like most small business owners, you started a business based on owning your company, and doing something that you like very much.

However, as your business has grown and as you plan further growth, you will see how important it is to have good control over your finances. The truth is that money makes a business grow.

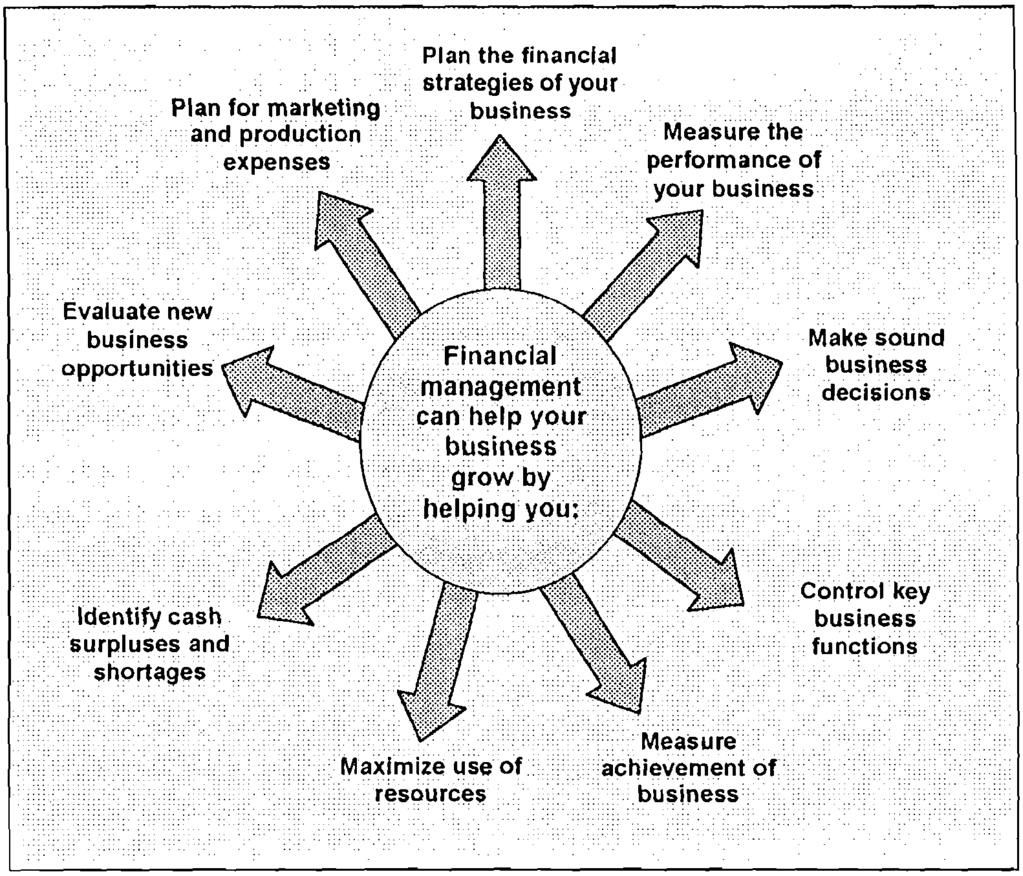
Important

The efficient and successful management of the finance of the business is essential to building a strong business that can grow and expand to meet your ambitions.

3. How Does Financial Management Help You to Grow Your Business?

As a growth oriented entrepreneur, you are concerned with the growth and expansion of your business. Managing financial resources efficiently and effectively is vital for all entrepreneurs to achieve their business goals. Finance is the life-blood of any organization, and every entrepreneur wants to earn a good return on his or her investment. To achieve your goals in an ever changing and highly competitive environment, you have to make the right strategic decisions that provide the business with opportunities for growth, and allow you to earn a good return on your business investment.

Your growing company is in a highly dynamic environment. As you develop existing markets and enter new markets, sales expand. Expanding sales require additional resources including labour, equipment and inventory. In addition, customers will demand more credit that you must extend in order to stay competitive in the market place. Financial management offers a system that helps you manage and control these important factors.



Financial management helps you to:

■ Plan the financial strategies of your business

Financial management provides you with key information to assist in the planning of financial strategies of your business.

> In Chapter 5, you will find the information about financial planning and control. Also, the Financial Management Growth Plan will help you in implementing the planning techniques to your business.

For your business to continue growing, you will have to expand your existing markets, develop new markets, introduce new products and increase market share. As sales increase, you may need to realign your productive process, purchase new machinery, technology, and restructure your organization.

You will find yourself with the task of reviewing your credit policies. An expansion of existing customer credit facilities and adding new accounts will place greater demand on the working capital of the business.

These activities require you to make key strategic decisions, and plan the financial strategies of your business. You need a system to help you access vital information, analyse it and make good decisions. Financial management gives you that system.

- ## Measure the objective factors that affect the performance of your business

The financial information system includes a series of reports that provide a monetary indication of the performance of your company. They help you to monitor the progress of your business toward achieving business goals and to take corrective actions when necessary.

For example, Income Statements will provide you with detailed information on your incomes and expenses. From statements for successive periods, it is possible to detect trends in different items of income and expenses, which would explain deteriorating profit margins.

Likewise, if your Balance Sheets for successive periods showed an increase in creditors, this could explain your recent shortages in cash.

You should also utilise a variance report to compare budgeted with actual performance, allowing you the opportunity to make necessary changes to get operations back on track.

- ## Utilise financial information to make sound business decisions

The financial information system provides you with a wide array of information that can be utilised to make better business decisions.

For example, you should carefully consider the net profit margin before you make an important decision to increase promotional expenses. The debtors' turnover ratio (accounts receivable) helps you monitor and adjust your credit and collection policies. The break-even analysis will help you make better decisions regarding pricing and production costs and volumes when you introduce new product lines.

- ## Control key business functions

Financial management provides you with a variety of tools and techniques to control and monitor the key business functions of marketing, production and human resources. For example, the sales budget will allow you to monitor the marketing function, and make adjustments as needed.

Your functional budgets and variance reports will help you in monitoring and controlling the production, human resource, and other functions in your business.

■ Measure the achievement of business objectives

Financial information is required to analyse and measure the achievement of key business objectives. You can compare the business achievements with targets that you set during the planning stage. You can compare your progress against last year's performance.

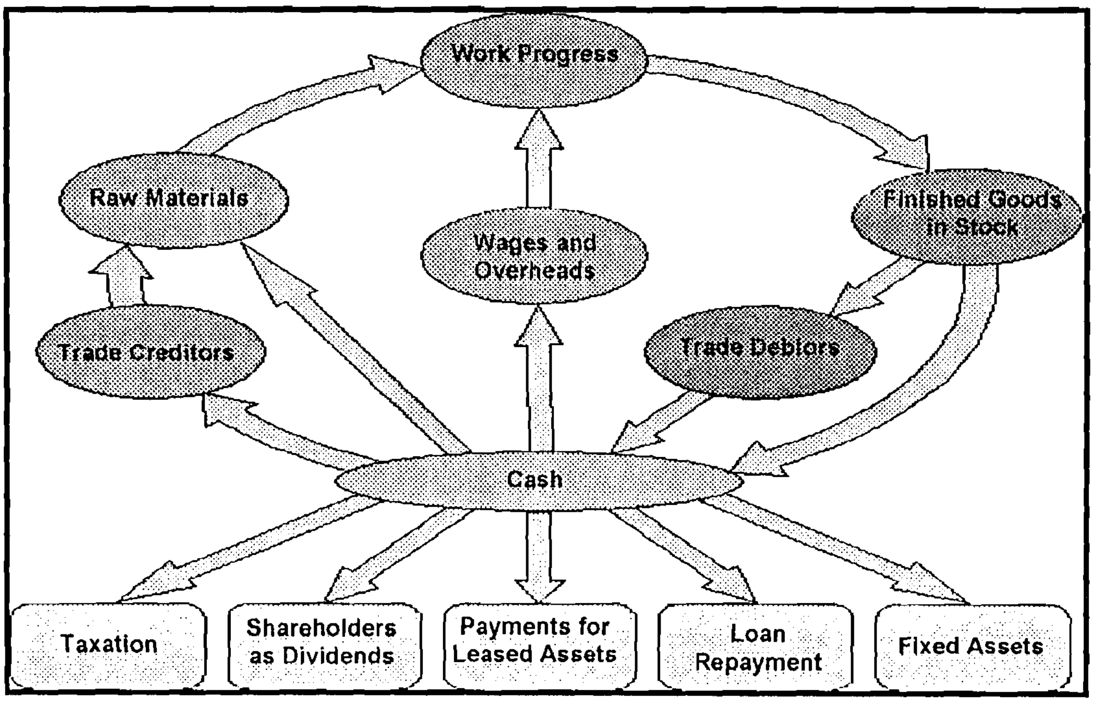
As an example, you can determine if you have achieved the net profit margins that you planned. You can compare this year's net profit margin with last year's figures. You can compare your financial achievements with industry averages, if available, or with your firm's best performance figures from years past.

■ Maximise use of resources and avoid cash shortages

If you are to succeed in rapid and sustained growth, you must maximise the efficient use of your limited resources. Cash shortages are one of the most common problems with growing firms. Many owners run to the bank the first instance their firm faces a shortage of cash. Unfortunately, what they do not realise is that these cash shortages are often entirely avoidable.

The following diagram illustrates the cash flow cycle. Cash constantly cycles through the business. First cash initially pays trade creditors; purchase the inputs (raw materials, labour, and overheads) to produce goods and services. Goods are sold to customers who pay, but often several months after they receive the goods or service. In addition, cash is ear marked to pay wages and overhead expenses to produce goods and services. On the other hand, cash must go toward tax payments to government, dividends to shareholders, repayment to lenders and payments to fixed assets.

Cash Flow Cycle



Consider the following common causes of cash shortages

- Excessive stock ties-up precious cash. You hold the stock in storage, and it only converts to cash when it is sold. While sitting in storage, it can loose value through wastage, obsolescence, or depreciation.
- Extension of credit to customers takes cash. You produce the goods or services, and incur the costs of production, but your customers don't pay you for many days after the goods are delivered to them. Overtime, also consumes your cash.
- New equipment purchases to expand production and sales will lead to increases in cash in the long run, but usually the new equipment must be paid for in cash.
- You may need to increase marketing expenses to push up your sales, and as demand for your product or services increases, you will need more workers. This increases labour costs. Once again, precious cash is drained from the company.

Financial management allows you to identify and plan for the use of your precious resources. It provides you with the information you need to evaluate your resource and financing needs. When you do go to the bank for a loan, it will be a planned and deliberate decision.

■ Evaluate new business opportunities

If a new business opportunity presents itself to you, how will you know if it is in your best interest to pursue it, or if the opportunity will be profitable? Will you have enough resources in your business to pursue the new opportunity without over-stretching yourself?

Financial management provides you with the techniques and the key information required in answering these questions. You can effectively analyse a business opportunity, and determine if it is worthwhile for you to engage in it. You can, also determine if the activity is feasible given your current resources.

■ Minimise disruptions caused by unforeseen events

The internal and external environments of your business are constantly changing. In many instances, you can plan for these changes. However, sometimes the unexpected happens. When it does, it can be very disruptive to the business operations. Financial management can minimise the disruptions caused by unexpected events.

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Remember the case study of Hana Juice Company (HAJCO) Ltd., the Jordan Valley products company that you found in Strategic Management module. Throughout this strategic financial management module, we will follow the efforts of Mr. Jameel to prepare his financial growth plan. By using it as an example, you will be able to understand and practice how financial tools and techniques can be used to prepare your financial growth plan.

A profitable company

Mr. Jameel knew his company was profitable based on financial statements he received from his CPA. He was able to draw a salary at the end of each year, and he had money left which he usually invested in the business. Mr. Jameel wonders if his company is really as profitable as it should be. He also wonders if there are ways to make the company more profitable.

Mr. Jameel has a bookkeeper who comes once a week and enters all the transactions into the books. The system is an old Module system, and once per year, Mrs. Jameel meets with a local CPA who helps them prepare statements for the Income Tax Department. The CPA provides financial statements including a profit and loss statement and balance sheet; however, Mr Jameel does not make much use of these statements preferring to run the business on a day-to-day basis.

Hana Juice Company (HAJCO) Ltd.
Income Statement for the year ended December 31
(J.D 000)

	Item	2002	2003
	Figures shown in thousands of J.D.	(JD 000)	(JD 000)
	Net Sales (Turnover)	314.00	408.00
	Less: Cost of Sales	152.00	196.00
	Gross Profit	162.00	212.00
	Selling and Distribution Expenses	16.00	20.00
	G&A Expenses	11.00	12.00
	Salaries	35.00	42.00
	Bad Debts	6.00	10.00
	Total Operating Expenses	68.00	84.00
	EBITDA	94.00	128.00
	Depreciation	21.84	24.72
	Amortisation	-	-
	EBIT	72.16	103.28
	Interest Charges	15.00	12.00
	EBT	57.16	91.28
	Corporate Tax @15%	8.57	13.69
	Net Income	48.59	77.59

Continued on the next page...

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Continued from the previous page...

Customer Credit Problems

HAJCO management noticed that, as their business grew, more and more of their customers demanded credit. Some of these customers were very loyal and ordered large quantities of product. Mr. Jameel felt that he could trust these customers, and assumed that they would pay on time.

Mr. Jameel met with his partner, the sales and marketing manager, and the sales staff and discussed the issue of customer credit with them. They all felt it was very important to extend credit to all of the customers. They said it seemed unfair to give credit to only few customers and then, have the others go without. The customers that did not get credit would complain, when they found out that they were being treated differently. After meeting with the sales staff and hearing their opinions, Mr. Jameel decided that he would extend the same amount of credit to all of his customers. He set the credit policy that customers could pay for their orders thirty days after they received the order. He decided that all customers would be allowed credit because that seemed fair.

After few months, Mr. Jameel noticed that his company was running out of money. Cash was always a problem, but now it was more persistent. This fact was even more surprising considering that sales were improving since they started to extend credit to customers.

Things go missing

HAJCO have a problem with employee petty theft that is common to many companies. Mr. Jameel had to dismiss employees frequently for stealing. Fortunately, no one has stolen enough money or inventory to do serious damage to the business. However, Mr. Jameel continues to worry that maybe one day someone would get away with stealing a lot of money.

Expansion

HAJCO are considering developing new markets in Europe and USA. Mr. Jameel is not so sure about the overall potential of these new markets, but he thinks he can sell enough of his products to allow him to expand the business and possibly make a better profit on the products he sells. He, also wonders if he should develop new varieties of products that are used in Europe and USA and not common in Jordan.

Mr. Jameel began to think about the possibility of expanding his factory to meet demand for his products. He had some vacant space on the plant location, and it would be no real problem to expand. He also knew he needed more equipment for the expansion, and he would need more workers.

4. Set objectives for your financial management plan to support your growth strategy

Any goal or objective for financial management should support the management growth strategy of your business. The business will require specific financial resources to fund growth, as well as, specific financial systems to help monitor and steer the business as it grows. It is critical to prepare the business finances to support the business expansion strategy in the early stages of the growth plan.

Clear objectives are the compass that directs you to achieve your business mission. Financial management is the co ordinator of your all other business functions, which includes marketing, human resources management and production management. Therefore, it is important to set clear long-term objective for your financial management function that support the business growth strategy.

Refer back to chapter two of your Strategic Management Module, where you find more details on how to set up goals, objectives and your business mission.

EXERCISE

Refer to the growth strategy that you developed in the Strategic Management Module, and prepare goals, long-term and short-term objectives for financial management function of your business.

My Business goals are:

Continued on the next page ...

EXERCISE

Continued from the previous page ...

My business long-term objective are:

My business short-term objectives are:

5. Chapter Summary

Financial management is the business management function that manages the acquisition and application of the financial resources of a business. It plays a key role in the formation of the primary business strategies and achievement of key business objectives.

Having a financial management objective in line with your mission statement is the foundation of your financial growth plan.

Financial management helps you evaluate and make a choice about the strategic growth strategy you will pursue. It helps you to ensure that the growth strategy is both profitable and achievable given your financial resources. Finally, financial management helps to monitor continuously your business as it expands to ensure that you stay on track, and avoid common pitfalls that can de-rail your growth plans.

The following chapters will deal with how to apply these financial management tools and techniques in practice.

6. Make an action plan for improving your implementation of financial management

Complete the form below to implement financial management in your business. The following action plan is useful when you prepare your financial growth plan, where you can have a master action plan for all aspects of your financial management.

You can find the forms for preparing your Action Plan in the Financial Management Growth Plan.

ACTION PLAN

OBJECTIVE (What to achieve?)	ACTIVITIES (What should be done?)	TIME FRAME (When should it be done?)		RESPONSIBILITY (Who should do it?)	RESOURCES (How it should be done?)	COMPLETED
		START	END			
						❑
						❑
						❑
						❑
						❑
						❑

Chapter 2

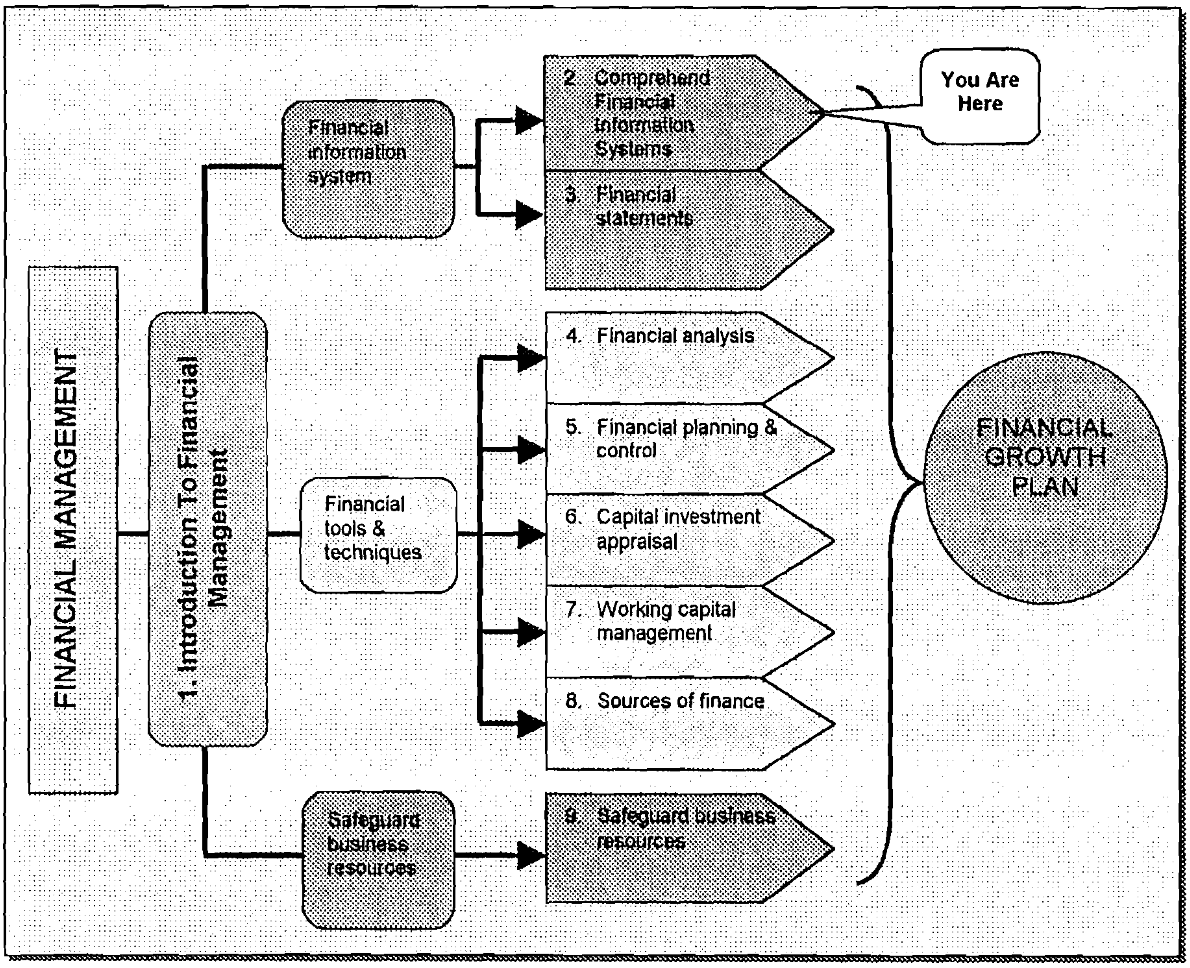
COMPREHEND THE FINANCIAL INFORMATION SYSTEMS

What you will learn in this chapter ...

The objective of this chapter is to enable you to understand the environment, and to 'predict' the direction things will go and then position your business accordingly>

After studying this chapter, and completing the exercises in it, and with the guidance of your business trainer, you should be able to:

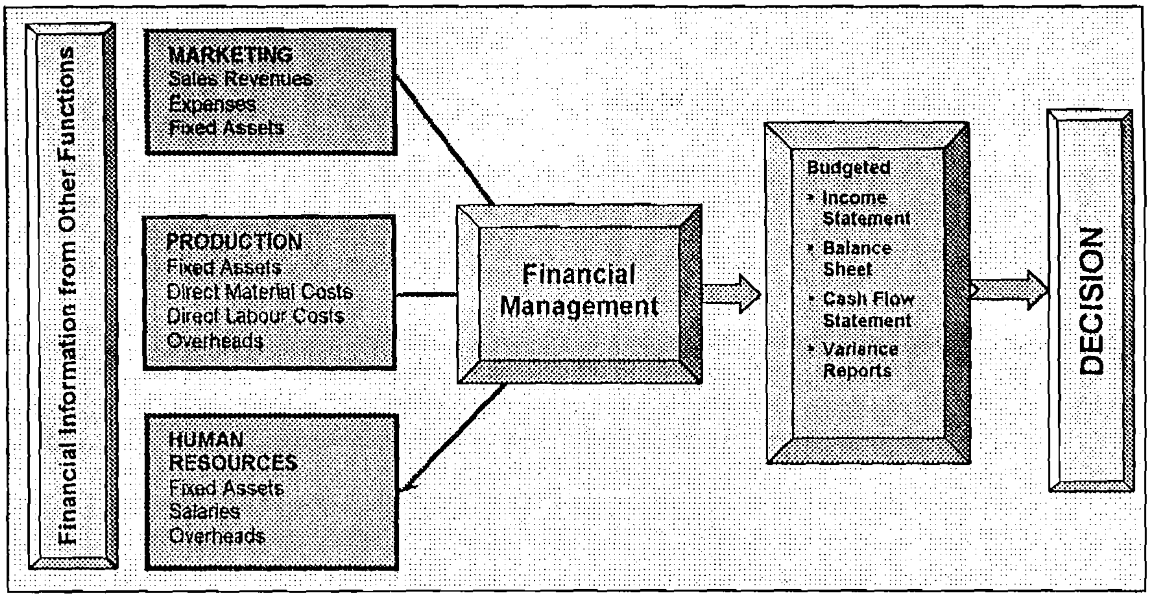
- **Identify sources of financial information.**
- **Explain the importance of record-keeping systems.**
- **Assess the need to implement computerised accounting systems.**
- **Adopt a computerised accounting system.**



1. Overview Of Financial Management Information System

Financial management depends on information that is provided in a timely manner from the various business departments including, marketing, production and human resources. In addition, information is gathered from outside sources to supplement the internal information. This information is reported on a regular basis and is then, compiled into a set of reports known as financial statements.

The diagram on the next page shows how information flows from the various functional areas of the business into the financial management system. Analyses and reports are developed, and used to make strategic business decisions.



Financial management is responsible for collecting and analysing information provided by the other business functional areas. This information is presented to management, and assists in the development of strategic management goals and objectives.

A Management Information System is central to the business decision making process. Information flows from the various departments including marketing, human resources, and production. This information is processed and analysed by the finance department. Reports are issued with key information that is utilised by the various departments for operation and planning activities.

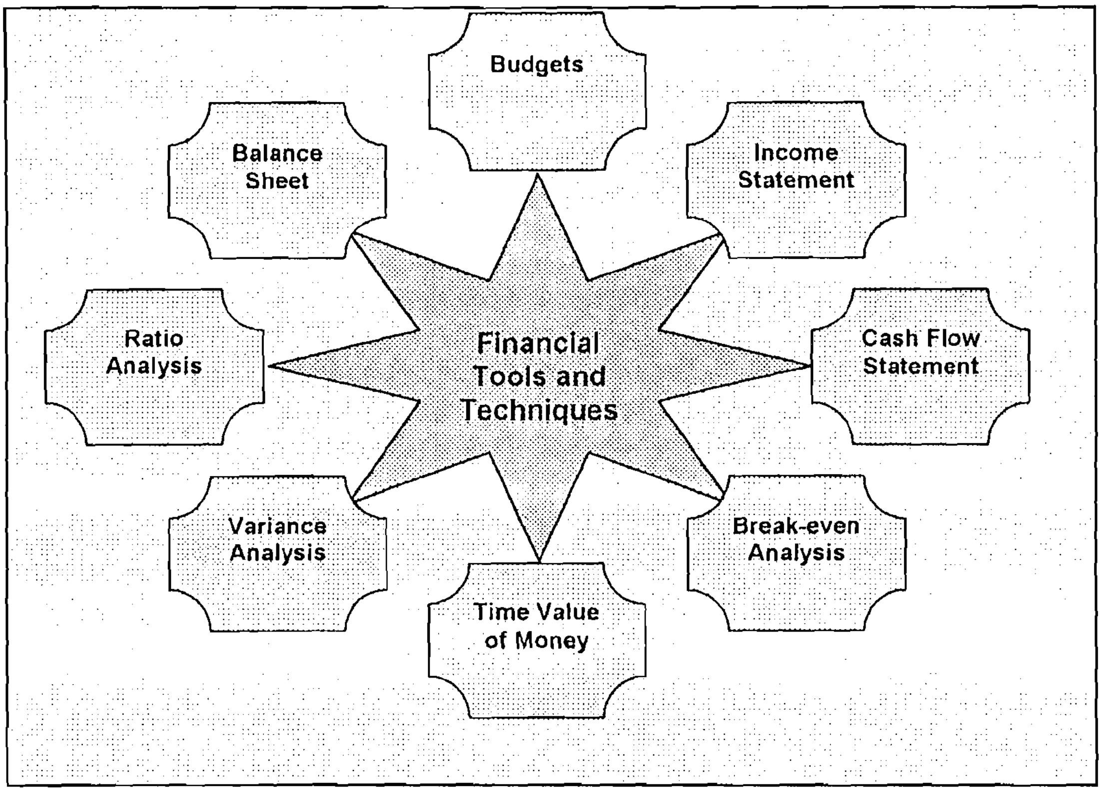
2. Overview of Financial Tools and Techniques

There are several tools and techniques that are generally used in financial management. These tools and techniques can be used to analyse the business performance, and monitor the business plan.

Financial management incorporates key tools to help you manage your business. These tools are:

- **Budgets**
- **Income statement**
- **Balance Sheet**
- **Ratio Analysis**
- **Cash Flow Statement**
- **Variance Analysis**
- **Break-even Analysis**
- **Time Value of Money Analysis**

The most common tools and techniques are shown in the diagram below:



- **Budgets**
  They are plans expressed in quantitative terms, usually financial. You use budgets to plan and control the growth of your business.

- **Income Statement (Profit and Loss Account)**
  It is the summary of all revenues and expenses of the business and the net income or loss of the business for a given period. The Income Statement is used to measure business performance, and can be closely monitored to detect performance trends.

- **Balance Sheet**
  It is a financial statement that shows the financial position of the business at a particular point in time. It is a "snap-shot" of the business, which shows all the assets, liabilities and owners equity of the business at a give time. You can evaluate the financial strength (or weakness) of your firm using the balance sheet.

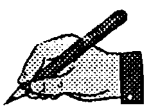
- **Ratio Analysis**
  It is a financial management technique used to analyse the financial performance, strength, or other business attribute by relating one financial statement figure with another. There are a number of categories of financial ratios that may be used to analyse and interpret the financial performance and position of your business. Ratio analysis allows you to compare your business performance and strength with past periods, or with similar businesses in your industry and determine if your business is on track to meet your established goals.

- **Cash Flow Statement**
  It explains the change in the cash position of the firm by showing you how much cash your business generated from operating activities, how much cash was used (or released) from investment activities, and the net cash effect of financing activities. The cash flow statement allows you to keep close tabs on the cash flows of your business.

- **Variance Analysis**
  It involves the comparison of budgeted and actual performance, the analysis of causes of deviations and taking necessary action. It allows you to closely monitor the performance of your business, to find the causes of the deviations between planned and actual performance, and take action quickly when necessary.

- **Break-even analysis**
  It is a technique that uses the relationships between costs, volume, and profits to make various operating decisions. The break-even point is the point of production and sales volume where neither profit nor loss arises. Knowing the break-even point of your business helps you to decide your minimum operating level. A comparison of the break-even point and the current or planned level of activity indicate if you are in a stable position or not. Break-even analysis also helps you to assess your ability to make changes in your selling price and production volume.

- **Time Value of Money**
  The value of a specific amount of money in the future is worth less than the same amount of money today. The return you get for today's investment must consider the opportunity costs of not having access to the money today and waiting for the money in the future. When you set financial objectives, and evaluate the performance of your business, you therefore, need to ensure that your return is worthwhile after taking into account the concept of the time value of money.



EXERCISE

1) Which financial management tools do you use today to monitor the performance and growth of your business?

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Continued on the next page...

EXERCISE

Continued from the previous page...

2) What was the profit (or loss) of your business last year? Which tool did you use to determine this?

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3) Did your business experience shortages? If yes, why do you think that happened?

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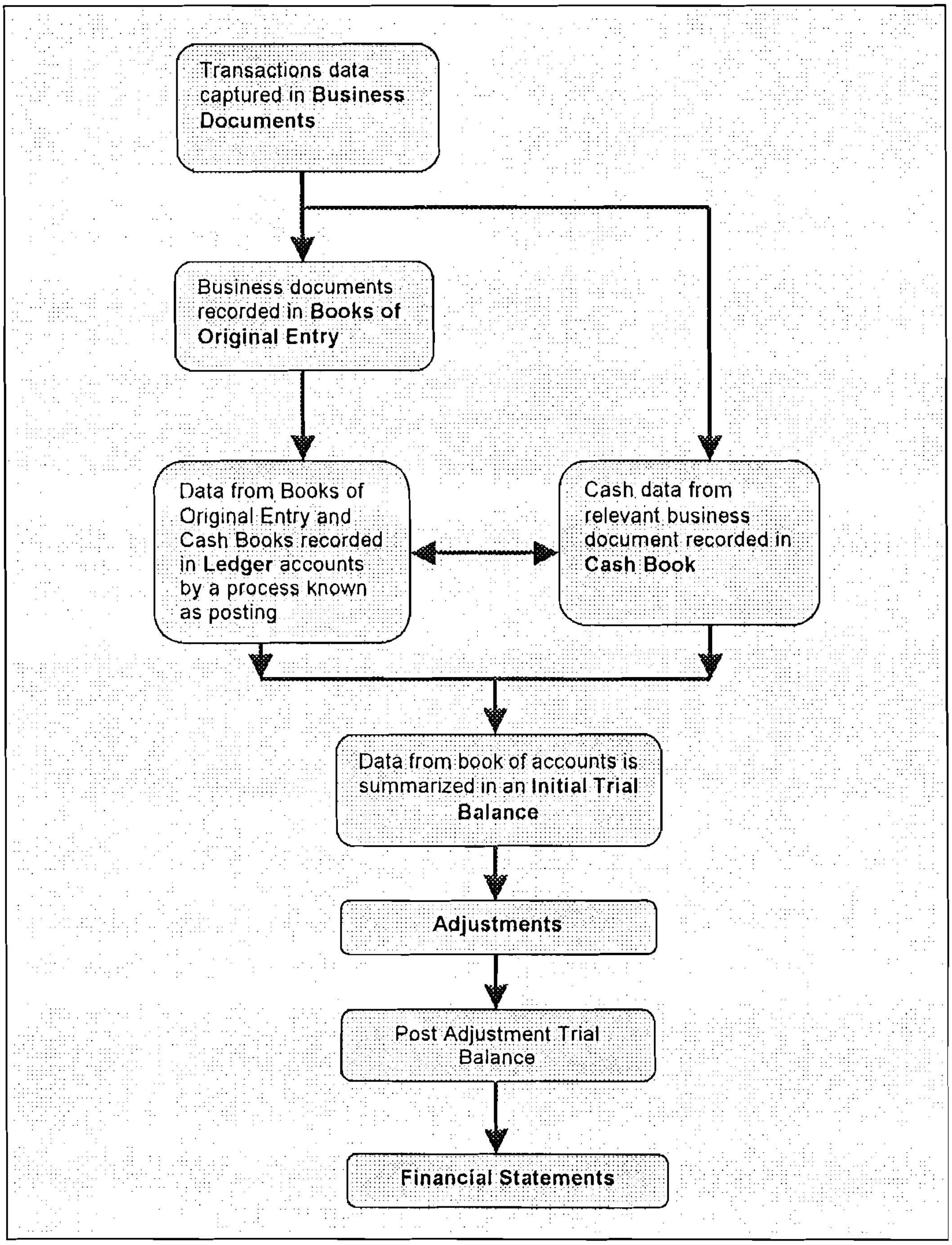
3. Sources Of Financial Information

Each of these statements is prepared from the record keeping system of the business. The financial record keeping system of a business consists of business documents and books of account. The chart shown in the next page shows the flow of financial information from the business (sources) documents, through the accounting system and finally, into the financial statements.



■ Business documents

A business document is a document that is used to record business transactions as they are recognised. (Business transactions are events that affect the assets, liabilities or equity of a business.) For instance, when you sell goods on credit, you capture the data in respect of the sale transaction in a sales invoice. Other examples of business documents include debit notes, credit notes, suppliers' invoices, deposit slips and check stubs. The term **source document** is alternatively used in place of business document.

- ### Books of account

It is a collective term used to describe the set of more permanent financial records created from data initially captured in business (source) documents. The term 'books of account' is a bit of a misnomer because the term does not only apply to records in bound books, but to records in both paper and computer files. The books of account you need to maintain will depend on the size and specific needs of your business.

- ### Books of original entry

For a medium size business, the transactions data captured in business documents may initially be recorded in books of account known alternatively, as books of original entry, books of prime entry, journals or day books. Books of original entry are essentially financial diaries used to record business transactions in a chronological order before they are recorded in the main book of account, the ledger. Typical examples of books of original entry are the sales day book, for recording high volume credit sales transactions; purchases day book for recording high volume credit purchases transactions; and the general journal, for transactions that do not warrant special journals.

- ### The ledger

The ledger, the main book of account, is a collective term for the set of records, in the form of accounts of the assets, liabilities, incomes, expenses and items of equity of the business. The ledger may be divided into different sections. For instance, the cash and bank accounts may be removed from the main ledger and be constituted into a section of the ledger known as the cash book. Other sections of the ledger that may be maintained, if the number of the accounts involved warrants doing so would be the sales (debtors) ledger for debtors' accounts as well as the purchases (creditors) ledger for creditor's accounts. The general ledger contains the accounts, which do not warrant the creation of a special ledger.

Accounts in the ledger (including the cash book) are maintained using the double entry system of book-keeping. Double entry book- keeping is a system of recording financial transactions in a way that reflects the dual effect of each transaction. For instance, if you purchase goods for JD 6,000 on credit, you simultaneously increase your stock of goods by JD 6,000, and your liability of creditor by the same amount. If your debtor settles an outstanding account of JD 2,500 by check, your asset of debtor is decreased by JD 2,500, whilst your asset of cash at bank is increased by the same amount.

- ### Trial balance

At periodic intervals, the accounts in the ledger (including the cash book) are summarised in a trial balance. A trial balance is a listing of account names and their respective balances. The trial balance serves the dual functions of:

a) Checking the arithmetical accuracy of the double entry book-keeping of the business

b) Providing a convenient summary of accounts and account balances to be used to prepare financial statements.

- **Adjustments**

  Financial statements are prepared on the accrual basis of accounting. Under this basis, business transactions and other events are recognised when they occur, and not as cash or its equivalent is received or paid. Business transactions are, therefore, recorded in the accounting records, and reported in the financial statement of the period to which they relate. For instance, if at the end of an accounting period interest on investment amounting to JD8000 has been earned, but not yet received, an adjustment should be made to include the amount under revenue in the income statement, and to show the same amount as a debtor in the balance sheet at the end of the period. After an initial trial balance has been extracted, therefore, adjustments should be made for such items as expenses incurred but not yet paid (accruals), expenses paid for but not yet incurred (prepaid expenses), income received in advance and outstanding income, in order to ascertain the correct figures for expenses and income /or the period and the assets and liabilities at the end of the period.

4. Importance of Record-Keeping System

Your record keeping system should generate financial statements that provide you with useful information for making economic decisions. Good financial management begins with a good record-keeping system.

> **For financial information to be useful, it needs to be understandable, relevant, reliable, comparable, timely and cost justified.**

- **Understandability**

  Your financial statements should provide information you can readily understand. For you to understand the information, you need to have a reasonable knowledge of accounting, and be willing to study the information contained in the statements with due diligence.

- **Relevance**

  Items included in your financial statements should be appropriately classified, so as to separately and accurately disclose items that would influence your decision-making. Insignificant items may need to be aggregated. If your Income Statement, for instance, separately discloses too many small items of expenses, it will end up being too cluttered and hinder your understanding of what is happening with your expenses.

- **Reliability**

  Your financial statements should be a fair representation of the transactions and events that they purport to represent. They must be complete and free from significant errors.

- **Comparability**

  You must be able to compare the financial statements of your firm through time in order to identify trends in its financial performance and financial position. You must also be able to compare your financial statements with those of comparable firms. To facilitate comparability, your financial statements should, as much as possible, be consistently prepared in accordance with standard accounting practice.

- **Timeliness**

  You need to have timely access to quality information for your financial management systems to make any difference in your business. For a growing business, access to timely and accurate information is the difference between success and failure. If there is undue delay in the production of your financial statements, they may lose their relevance. You may need to use estimates in preparing your financial statements if waiting for more accurate information is going to reduce the usefulness of the statements.

- **Cost effectiveness**

  The cost of your system should not exceed the benefit you derive from it. There are a variety of business record-keeping systems in use today. Some of these systems are quite simple, but they get the job done. Other systems are complex and address every aspect of the business operation. Your record-keeping system should be simple enough for you to understand it, whilst providing you with the information you need to operate and grow you business.

Your record-keeping system should provide you with the information that helps you control vital elements of your business such as:

- Changes in revenues and expenses
- Amount of credit sales, and the quality of debtor accounts
- Inventory levels
- Expenses
- The ability to meet tax and other government requirements
- Closely monitor and improve profit margins
- Closely monitor and improve cash flow
- Closely monitor your business assets and liabilities
- Control the financial risks facing your business

You should have an accountant to advise you on the type of record-keeping system that is most suitable for your business. The accountant should also set the system up for you and regularly review your business records to make sure they are accurate and reliable.

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Although Mr. Jameel has a record-keeping system, but it is not an automated one. He keeps track on his records by using some Microsoft Excel sheets and some manually produced sheets. His main problem is the delay in getting the financial data when he needs it. Mr. Jameel has reached to this conclusion after evaluating his record-keeping system according to the key criteria as follows:

Characteristic	Score (1=worst / 10=best)									
Understandable	1	2	3	4	5	6	7	8	9	10
Relevance	1	2	3	4	5	6	7	8	9	10
Reliability	1	2	3	4	5	6	7	8	9	10
Comparability	1	2	3	4	5	6	7	8	9	10
Timeliness	1	2	3	4	5	6	7	8	9	10
Cost effectiveness	1	2	3	4	5	6	7	8	9	10
TOTAL SCORE	42									

By scoring 42 out of 60, Mr. Jameel is now aware of the specific areas of development of his record-keeping system.

Result: Following is the key for evaluating the financial information in your business:

Total Score		Interpretation
Below 30 Points	➔	Your record-keeping system is inefficient, and you need to improve your system to contribute to your growth. You should focus on the points with a score below 5.
31-45 Points	➔	Your record-keeping system is somehow efficient, but there is still a need to improve certain areas of the system to help you grow your business. You should focus on the points with a score below 5.
46-60 Points	➔	Your record-keeping system is efficient, and you need to maximisese the information to achieve your growth targets. However, you should focus on the points with a score below 5 if you have any.

EXERCISE

Evaluate the record-keeping system in your business based on the following criteria:

Characteristic	Your Score
1. Understandable	1 2 3 4 5 6 7 8 9 10
2. Relevance	1 2 3 4 5 6 7 8 9 10
3. Reliability	1 2 3 4 5 6 7 8 9 10
4. Comparability	1 2 3 4 5 6 7 8 9 10
5. Timeliness	1 2 3 4 5 6 7 8 9 10
6. Cost effectiveness	1 2 3 4 5 6 7 8 9 10
TOTAL SCORE	

5. Importance of Developing a Computerised Financial Management System

If you really want to successfully grow your business, you need to have access to accurate and timely financial information. Small companies, especially when they are new, typically have simple module record keeping systems. These systems are usually adequate, because the companies have relatively low levels of activity and few transactions to record.

As a company grows, the module records become more elaborate and complicated. It becomes more difficult to utilise the records for the purposes of managing the business. The business finds that the process of summarising module financial records can take several days and considerable labour.

With the advent of computerised record-keeping systems, businesses are able to access vital financial information on a real time basis. Key financial reports can be produced on a daily basis if so desired. Progress of the firm can be tracked, and frequent updates are possible.

At one time, the costs of computers and computerised systems were so high that small companies could not afford them. Today, a growing business finds it both cost effective and critical to install a computer based record keeping system.

Several computer software accounting packages designed for smaller companies that provide all the features you need to grow your business exist. **Jamshid, Ideal Accountant** is one such programme commonly used by many small and medium businesses. They are fully functional and relatively easy to use.

Delta informatics, GCESoft, ITAC, Eskadenia, ATS, and Galaxy the preceding companies produce computer-based accounting packages for small business. They offer a complete solution for business accounting needs.

If you have reliable access to the Internet, you may consider an internet-based accounting system. The **Netledger** system by **Oracle Small Business** is the first Internet based small business accounting system. The major advantage of this system is that all of the business records are stored on a main computer owned by **Oracle Small Business**. No matter where you are in the world, you can always access your accounting records safely and securely via the Internet.

6. Moving to a Computerised Accounting System

Some financial statements may need to be prepared at fairly regular intervals. For instance, income statements may need to be prepared on a monthly basis, shortly after the month end. In a really volatile environment, cash flow projections and reports may need to be prepared every two weeks. (Cash flow projections are dealt with later in this module.) Other financial statements may be prepared at longer intervals, like quarterly, half yearly or annually.

One way of ensuring accurate and timely financial information is by computerising the accounting system. Small businesses, especially when they are new, typically have simple manual record keeping systems. These systems are usually adequate, because these businesses have relatively low levels of activity and few transactions to record. At this stage, the business does not need to computerise the accounting system. In any case, the cost of an accounting system should not exceed the benefits it offers.

As a company grows, the manual records become more elaborate and complicated. It becomes more difficult to utilise the records for the purposes of managing the business. The business finds that the process of summarising manual financial records can take several days and considerable effort.

With the advent of computerised record-keeping systems, businesses are able to access vital financial information on a real time basis. Key financial reports can be produced on a daily basis if desired. Progress of the firm can be tracked, and frequent updates are possible.

At one time, the costs of computers and computerised systems were so high that small companies could not afford them. Today, a growing business should find it both cost effective and critical to install a computer based record keeping system.

When you decide to move your accounting records to a computerised system, you should follow a systematic process.

Five steps are outlined below to help you manage this transition.

a) **Recruit a professional financial expert**. Many small business owners make the mistake of purchasing the first computer-based accounting package they come across.

b) **Determine your company's record-keeping needs** Work closely with your accountant to determine your record-keeping needs. Your accountant should be able to evaluate your business's record keeping needs and recommend the right system for you.

c) **Identify and evaluate computerised financial management systems**. Talk to the experts. There are many systems available, and the right system for you will depend on your specific business requirements.

d) **Choose the system that best meets your needs**. The computerized accounting system you finally choose to install in your business should meet the information needs of your business.

e) **Implement a computerised financial management system**. You should work with your accountant to develop a process, and schedule for moving your record-keeping system on to the computer. In some cases, the process may be very simple and take a short period of time. For a more complex company, the process may take several weeks, and require good planning.

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Mr. Jameel decided to use a computerised financial system, so he sub-contracted a professional financial expert to determine the company's record-keeping needs, and to identify and evaluate computerised financial management systems that fits the specific needs of HAJCO and provides him with relevant reports on timely basis.

The financial expert advised Mr Jameel of a ready-made package that is produced by one of the Jordanian software companies after analysing the specific needs of HAJCO, and properly understanding the specific objectives of having a computerized system. The implementation of the selected computerised financial management system required the involvement of Mr. Jameel who required training on the new system, and suggested some modification of the reporting structure to fit the management needs.

After using the software for three months, Mr. Jameel noticed that he gets more detailed financial reports much faster than before, which helped him a lot in making decisions for any recovery actions before having complications of any deviations.

1) Do you think that Mr. Jameel did the right thing by implementing a computerised financial system?
2) What are the advantages that Mr. Jameel gained from sub-contracting a financial expert to help in selecting the system?
3) Will the benefits of employing an expert and installing a system warrant the outlay required? Explain how you feel Mr.Jameel should quantify his decision.

7. Chapter Summary

Sources of financial data: Your business collects data using many source documents, including invoices, receipts, and other business documents. This data is recorded into various books of original entry and then, into accounts maintained in the ledger. On a regular basis, this data is summarised from the accounts, and recorded into an initial trial balance. Adjustments are made to the initial trial balance. A post adjustment trial balance may then, be prepared from which the Income Statement, Cash Flow Statement and Balance Sheet are prepared.

Awareness of record-keeping systems: There are many types of business record-keeping systems. Some are very simple and others are quite complex. It is important that your record-keeping system provide you with timely and accurate information to enable you to make good financial management decisions and to control your business.

Computerised record-keeping: Computerised record-keeping systems represent a popular solution for fast growing companies. Financial statements can be produced much more quickly using a computerised record-keeping system. This enables you to make better management decisions, and to control your business more effectively. There many excellent computerised business record-keeping systems designed to meet the needs of fast growing small businesses and attune to Jordanian financial legalities.

8. Make an action plan for improving your skills of financial information system

Complete the form below to adapt financial information system in your business. The action plan shown in the next page is useful when you prepare your financial growth plan, where you can have a master action plan for all aspects of your financial management.

You can find the forms for preparing your Action Plan in the Financial Management Growth Plan.

ACTION PLAN

OBJECTIVE (What to achieve?)	ACTIVITIES (What should be done?)	TIME FRAME (When should it be done?)		RESPONSIBILITY (Who should do it?)	RESOURCES (How it should be done?)	COMPLETED
		START	END			
						❑
						❑
						❑
						❑
						❑
						❑

ACTION PLAN

OBJECTIVE (What to achieve?)	ACTIVITIES (What should be done?)	TIME FRAME (When should it be done?)		RESPONSIBILITY (Who should do it?)	RESOURCES (How it should be done?)	COMPLETED
		START	END			
						❑
						❑
						❑
						❑
						❑
						❑

Chapter 3

UNDERSTAND FINANCIAL STATEMENTS

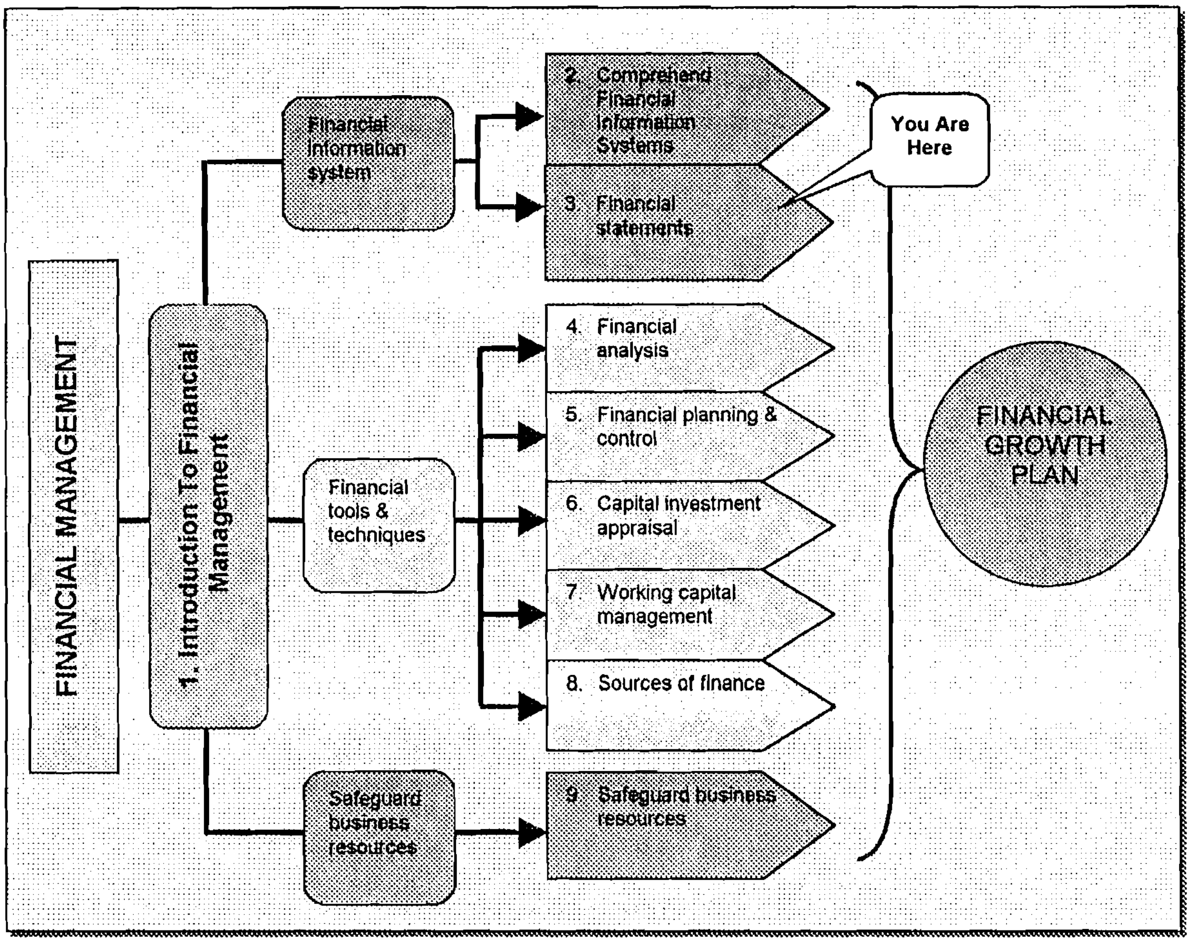
What you will learn in this chapter ...

After studying this chapter, and completing the exercises in it, and with the guidance of your business trainer, you should be able to:

- **Identify the components of basic financial statements.**
- **Explain the contents of the income statement.**
- **Depict the contents of the balance sheet.**
- **Illustrate the contents of the cash flow statement.**

Financial statements provide you with information to enable you to continually monitor and evaluate the financial performance, financial status and cash flow situation of your business. Three key financial statements used by businesses:

- **The Income Statement (of which the most common form is the Profit and Loss Account)**
- **The Balance Sheet**
- **The Cash Flow Statement**



1. What are financial statements?

Financial statement demonstrates the following:

> ***Financial statements*** are summaries of the transactions of a business presented in a structured manner to give information concerning the business

- **Financial position:** what does the company own, how much does it owe, how healthy is it?
- **Financial performance:** is the company profitable? Is the company growing?
- **Cash flow:** does the company generate enough cash to finance its operations and growth? Where does the money come from and where does it go?

The financial statements of a business are prepared from the bookkeeping records of the business. The book keeping system consists of business documents and books of account, follows later. However, the goal of this training manual is to help business managers use this financial information as a tool for good management. It is not our intention to teach the accounting process, but limit the discussion to the level of knowledge needed by business managers.

2. Why financial statements are important for a growth-oriented business

In the early stages of a business, financial statements tend to be prepared for the purposes of satisfying external parties e.g., local tax authorities and the bank if it provides loans or credit facilities. Once prepared, submitted to the tax authority and the bank, the statements are filed and often forgotten. In many cases, an external accounting firm prepares these financial statements, and the only interest shown by the proprietor is to know after the event how much profit he/she can draw out for himself/herself.

> **As the company grows and becomes more complex, you will soon realise that you need regular and reliable financial information to support your decisions, and to monitor the performance of the business.**

Accounting throughout the world has developed a set of rules for defining correct accounting practices, and a standardised set of financial statements to meet the needs of most businesses. The form of presentation may vary from country to country, but the basic concepts are quite constant by implementing **Generally Accepted Accounting Principles (GAAP)**. The financial statements used universally by businesses consist of:

> **The presentation of the financial statements is in accordance to GAAP except for the income statement were there are some items that are not required, but still useful for financial analysis by lenders and investors (such as EBITDA and EBIT, which clarified later in this chapter).**

- **The *BALANCE SHEET***

This document gives information on all the ASSETS the company owns and uses in the business; all the LIABILITIES the company has towards other parties (i.e. the money it owes) and the difference between the two, being the EQUITY, the value of the owners' investment in the company. The balance sheet can be described as a snapshot, as it shows the financial position at a specific moment in time.

> ***Balance sheet*** is the financial statement that shows the financial position of the company at a given moment in time.

- **The *INCOME STATEMENT* (or Profit and Loss Account)**

This document shows:

- The REVENUES or income derived from the company's sales of goods and services;

> ***Income statement*** is the financial statement that shows revenues and expenses of the company to measure its profit and loss performance for a specific period.

- The COST of making those goods or providing the services;
- The EXPENSES for operating activities, such as sales and administration; the COST OF FINANCING including such items as interest paid and the TAXES to be levied on the profits.

The sum of the revenues less costs, expenses, financing costs and taxes gives the PROFIT or LOSS of the company. The income statement covers the business activity over a specified period; it can be compared to **a motion film of activity**, as compared to the **balance sheet snapshot**.

- **The *CASH FLOW Statement***

Makes the bridge from the Income statement to the net cash movements for the same period, [also a film of activity over a period]. Designed to highlight how much cash is generated by the normal business operations, consumed by the business operations. If this is negative; how much of this cash is reinvested in such items as Buildings, Machinery, Office equipment, Vehicles etc. to enable the desired growth of the business, and how much outside financing was needed to fund the investment or operating needs, as well as, the source of such funds.

> ***Cash flow statement*** is the financial statement that shows movement of cash inflows and cash outflows of the company in a specific period.

> Additional owner funds, bank loans etc., are further discussed in Chapter 8: Scrutinize Your Sources of Finance

3. The main users and uses of financial statements

We now, start to understand that the financial statements are prepared for two distinct groups of users:

- **External users of financial statements**

Generally, the local law and Accounting bodies (Institute of Chartered Accountants) will define the Accounting and reporting rules to be followed for information going into the public domain. It will tend to be rather succinct and avoids giving too much information to competitors. This is known as Fiscal or Financial Accounting and the information often has to be filed with local authorities such as company registration offices. **You are advised to use an external accounting firm to ensure compliance with all such requirements.**

The external users of financial statements include the tax authorities, which need to calculate the tax charge and loan creditors who need to ensure that the company is solvent. There may, also be other external parties interested in the financial strength and performance of the company, such as minority investors, customers and suppliers who want to be sure the company is a sound business partner.

Internal users of financial statements

The financial statements for internal uses have potential for critical management activities including:

- Business planning, including the long-term (3-5 year) strategic plan which must contain summary financial quantification of the plan to relate it to growth and profitability goals
- Budgeting, the short term, generally one year, detailed financial plan, which sets the objectives in financial terms for each part of the business. Generally, broken down into months or quarters (See Chapter 4 for the Strategic Finance Plan and the Budget).
- Performance measurement and analysis, the assessment of the over or under achievement of each part of the company compared to budget, for purposes of fixing remuneration and rewards; making corrective action plans and redirecting the resources of the company, if necessary (see Chapter 3 for Financial Analysis tools).
- Decision support, this is analysis and evaluation necessary to ensure strategic and operational decisions support the goals and objectives of the company (see Chapter 5 for Investment Appraisal tools).

The users of financial statements within the company, are you, the entrepreneur, and management of the company who need much more detailed information and on a very timely basis

The basic accounting rules will be the same as those applied for financial accounting, but the level of detail will be much greater and adapted to the structural requirements of each company. This is known as Management Accounting, and the company is free to define the level of detail it requires, taking into account that the cost will increase, as more detail is required.

EXERCISE

Identify the segments of your business for which you need regular financial information in order to plan and monitor investments and profitability. Be practical, do not try to find every conceivable segmentation, but try to focus on those dimensions of your business which are strategically important to you corresponding to the level at which you make major decisions, and the main sections of your organization, so the information can be aligned with responsibilities.

4. The content of the basic financial statements

Now, that we have considered the need for financial information, the three basic financial statements and how they are used, let us look in more detail at the content and presentation structure of the Balance Sheet, Income Statement and Cash Flow Statement.

4.1 Balance sheet

The balance sheet shows the financial position of your company at a particular point in time. The balance sheet represents the basic accounting equation.

Assets less Liabilities = Equity (the value of the company to its owners)

The balance sheet shows:

- How funds are invested in the business (the assets, the items the business owns in order to function)
- The sources of those funds (money borrowed externally for financing,
- Equity, (the proprietors' money invested in the business).

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

The following is the Balance Sheet of HAJCO Industries at December 31, 2003, with comparative figures for 2002. The notes that follow, and which are cross-referenced to the balance sheet explain the nature and significance of each particular balance sheet line items

Hana Juice(HAJCO) Company
Balance Sheet as of 31 December
(J.D. 000)

[A]	Assets(in thousands of JD)	2002	2003
[B]	***Current Assets:***		
[C]	Cash on hand and at banks	36.77	62.94
[D]	Inventories	170.00	180.00
[E]	Accounts Receivable	27.00	34.00
[B]	**Total Current Assets**	**233.77**	**276.94**
[F]	***Fixed Assets:***		
	Fixed Assets: At Cost	273.00	309.00
	Less Accumulated Depreciation	39.68	64.40
[F]	**Net Book Value of Fixed Assets**	**233.32**	**244.60**
[G]	Other Assets	-	-
[A]	TOTAL ASSETS	467.09	521.54
[H]	**Liabilities and Shareholders Equity**		
[I]	***Current Liabilities***		
[J]	Accounts Payable	122.70	116.57
[K]	Accrued Expenses	25.00	20.00
[H]	**Total Current Liabilities**	**147.70**	**136.57**
[L]	***Long Term Liabilities:***		
[L]	Long Term Loans	90.00	78.00
[L]	**Total Long Term Liabilities**	**90.00**	**78.00**
[M]	***Shareholders Equity:***		
[N]	Paid-up Capital	100.00	100.00
[O]	General Reserves	40.00	40.00
[P]	Retained Earnings	89.39	166.97
[M]	**Total Shareholders' Equity**	**229.39**	**306.97**
[H]	TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	467.09	521.54

Continued on the next page...

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Continued from the previous page...

When you read the balance sheet of **HAJCO,** comment on the points for discussion:

1. The value of the investment in the business (shareholders' equity):

2. The composition of the business' assets, current and long-term:

3. The ability of the business to meet its obligations as they fall due, measured by the business' net current assets or working capital:

4. The extent to which the business is financed by long-term debt as compared to equity:

■ The elements of the balance sheet

[A] Assets: This side of the balance sheet represents the uses of available funds into current, fixed and intangible assets. The assets include the following items, as shown in **HAJCO** balance sheet.

[B] Current assets: Current assets include all assets that can be liquidated in the short term. It consists of cash and cash equivalent assets.

[C] Cash: including bank accounts and cash equivalents such as, short-term investments of surplus cash.

[D] Inventories: goods held for resale, including raw materials, finished goods and work in process.

[E] Accounts receivable: from customers for credit sales (Debtors)
Any other items expected to be realised in, or held for resale or consumption in the normal course of the enterprise's operating cycle, within the coming 12 months.

[F] Net book value (Fixed Assets at cost less accumulated depreciation): These are the items of equipment, which are acquired for use in the business, and not for conversion into cash in the normal course of business. These include all buildings (if owned), manufacturing machinery, office machinery, vehicles and any other physical items which will be used over several years, and constitute the underlying physical infrastructure of the business. The charge against profits for the use of these items is handled through a mechanism called "Depreciation". An example of this is given in the following Case Study on the next page.

[G] Other assets are non-physical assets of long-term value to the company. Examples of intangible assets are trademarks, patents, and franchises. These are also written-down proportionately over their useful lives, similar to depreciation, but in the case of Intangible assets, this is known as amortisation. Also included in this category would be **Trade Investments** representing the amount invested in other businesses for the long-term for strategic reasons, such as to firm up a business relationship. Short-term investments of surplus cash would be classified as Current Assets.

[H] Liabilities and shareholders equity: This represents all the items necessary for the functioning of the business. In principle, this side of the balance sheet includes sources of funds available for the business. All **LIABILITIES:** stated at their actual committed amounts (and where this information is not available), at the best estimate of the commitment.

The **SHAREHOLDERS' EQUITY**: represents the owners' contribution to finance their business.

[I] Current liabilities: Current liabilities are amounts owed by an enterprise payable within the next twelve months.

[J] Accounts payable: (Creditors) for goods and services purchased on credit for the business but yet unpaid.

[K] Accrued expenses: this is similar to Accounts payable, but where the invoice has not yet been received, and the amount owed is estimated

[L] Long-term Liabilities: are amounts owed by the firm, and which are payable beyond one year. They generally, represent long-term loan capital invested in the business for a fixed period and a fixed interest rate. The terms of the loan may be guaranteed by a charge on certain assets (e.g. a mortgage on land and buildings), or by certain restrictions on the way the company is managed, such as maintaining a certain level of liquidity.

[M] Shareholder's equity, Shareholders' equity represents the investment of the owners in the business. For a company, owners' equity consists of share capital and reserves.

[N] Paid-up capital is the nominal value of the shares that the business has actually issued.

[O] General reserves represent profits or surpluses that are reinvested in the business. A company may also have non-distributable reserves. For example, some countries require a percentage of profits to be held in a statutory reserve to prevent shareholders taking out all the accumulated profits as dividends. In this way, the stability of the company is improved.

[P] Retained earnings are the profits that have been reinvested into the business since the creation of the company. These may also be used to distribute dividends to the shareholders to remunerate them for use of their capital invested in the business.

The retained profits at the end of each year comprise the accumulated profits invested in the business at the beginning of the year; plus the profit for the year; less transfers to reserves and dividends paid to shareholders. For **HAJCO** 2003 and 2002, these movements are shown in the Case Study on the next page:

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

HAJCO retained profits reconciliation

In thousands of JD

	2002 J.D.000	2003 J.D.000
Beginning retained profits	40.80	89.39
Add: Profit for the year	48.59	77.59
Less: Transfer to general reserve	0	0
Less: Dividends to shareholders	0	0
Ending retained profits	89.39	166.97

From this table we can see that **HAJCO's** management has chosen to reinvest all the profits for the two years and, out of prudence, have set-up a general reserve, which is unable to be used for dividends without the specific approval of the shareholders.

4.2 Income Statement (Profit and Loss Account)

The income statement shows the calculation of the profit or loss made during a particular period, by subtracting the costs for the period from the revenues earned during the same period. The specific form of income statement varies depending on the type of the business operations.

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

The following is a detailed Income statement of **HAJCO**. The notes that follow are cross-referenced to the income statement. They explain the line items appearing in the statement:

Hana Juice Company (HAJCO) Ltd.
Income Statement for the year ended December 31
(J.D.000)

	Item	2002	2003
	In thousands of JD		
[I]	Net Sales (Turnover)	314.00	408.00
[II]	Less: Cost of Sales	152.00	196.00
[III]	**Gross Profit**	**162.00**	**212.00**

Continued on the next page...

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Continued from the previous page...

	Item	2002	2003
	Selling and Distribution Expenses	16.00	20.00
	G&A Expenses	11.00	12.00
	Salaries	35.00	42.00
	Bad Debts	6.00	10.00
[IV]	**Total Operating Expenses**	**68.00**	**84.00**
[V]	**EBITDA**	**94.00**	**128.00**
[VI]	Depreciation	21.84	24.72
[VII]	Amortization	-	-
[VIII]	**EBIT**	**72.16**	**103.28**
[IX]	Interest Charges	15.00	12.00
[X]	**EBT**	**57.16**	**91.28**
[XI]	Corporate Tax @15%	8.57	13.69
[XII]	**Net Income**	**48.59**	**77.59**

Cost of sales is calculated as follows:

	2002	**2003**
	J.D. 000	**J.D. 000**
Beginning Inventory	35.00	46.00
Production cost:		
Raw material	67.00	73.00
Factory wages	21.00	22.00
Factory rent	11.00	11.00
Electricity and water	9.00	11.00
Depreciation, Machinery	13.00	13.00
Total production costs	121.00	130.00
Total available	156.00	176.00
Less: Closing inventory	46.00	33.00
Cost of Goods sold	110.00	143.00
Distribution costs	42.00	53.00
Total cost of Sales	152.00	196.00

■ The elements of the Income Statement

[I] Net Sales, Net Sales alternatively known as **turnover**, consists of the net revenue earned from the sale of goods and services during the period. Sales are referred to a **Net** to reflect the deduction of discounts, allowances and returns from the full list price of products sold.

[II] Cost of Sales (or Cost of Goods Sold), this represents the full cost of buying (for a trading company) or manufacturing (for a manufacturing company). The products or services delivered to customers, which are included in Net Sales above. Note that Cost of Sales is the cost of the products sold, not the production costs of the period.

[III] Gross Profit, this is the difference between the sale price and the manufactured cost of goods sold. It is critical to set and maintain this margin, as high as possible, as this serves to finance all the operating and financial costs, as well as, income taxes. The ability of the company to finance future growth from its own profits is dependent, largely, on good management of the gross margin on sales.

[IV] Operating expenses, operating expenses are all the business costs that are not related directly to acquiring or producing the goods that are sold. These costs can be looked at either by the way in which the money is spent (traditional approach used above), or the purpose for which it is spent. The latter approach has the merit of understanding WHY the expense exists and aligning responsibility with the organizational structure. The following table illustrates this point:

Function/ Spend type	Sales & marketing	General & Admin	Research & Dev.
Salaries & wages	Sls/Mktg salaries	Mgmt/Finance etc Salaries	Engineers salaries
Selling & distribution	Sls/Mktg expenses		
Office supplies	Sls/Mktg office supplies	G&A office supplies	R&D office supplies
Electricity & water	Sls/Mktg utilities	G&A utilities	R&D utilities
Bad debts		Bad debts	
Depreciation	Sls/Mktg depreciation	G&A depreciation	R&D depreciation
Total	Total Sales/Mktg	Total G&A	Total R&D

[V] EBITDA – Earnings Before Interest, Tax, Depreciation and Amortisation, this is calculated by subtracting operating expenses (excluding none cash items such as depreciation) from gross profit to give the profit or loss resulting from the actual business operations, a most useful piece of information to management to know if the operating activities are profitable or not in cash terms.

[VI] **Depreciation,** this is the cost related to fixed assets and capital expenditures, which reflects the cost of using these assets during their useful life.

[VII] **Amortisation,** this is the cost related to other intangible assets, which reflects the cost of benefiting from these assets during the relevant period.

[VIII] **EBIT= Earnings- Before- Interest & Tax,** this is the profit earned for the period after charging all costs and expenses incurred to earn the revenue, but before taking into account the interest charges and taxes to be calculated on this profit.

[IX] **Interest charges,** this is the cost of servicing loans used in financing the company. It is separated from Operating expenses, as it results from the company's financing strategy, not its business operations.

[X] **EBT= Earnings -Before -Tax,** this is the profit earned for the period after charging all costs and expenses incurred to earn the revenue, but before taking into account the taxes to be calculated on this profit.

[XI] **Corporate Tax,** this is an estimation of the taxes payable in future periods, but which will be calculated based on this period's profits, irrespective of the future date when they will be assessed.

[XII] **Net Income,** this is the profit remaining for the owners of the business (the shareholders) after all costs and expenses have been taken into account. They are free to decide to either reinvest it in the business, without restriction, or by transfer to the general reserve (see D/E above); the unrestricted part is able to pay dividends on the shares.

4.3 Cash Flow Statement

In the above two sections, we saw how a business evaluates its financial position through the **Balance Sheet,** and measures its profitability through the **Income Statement.** There is however one more critical element to the role of Financial management, which is the management of the most critical Financial resource, the Company's cash.

Important

Cash, if not the heart and soul of the business, is certainly its lifeblood! There is no benefit to making profits unless those profits are converted into cash, which is needed to not only to pay current costs, but is primary source for financing the investments necessary to grow the business.

Accountants pay particular attention to providing management with clear visibility to the sources and uses of Cash resources to ensure these are being tightly monitored and carefully used.

It is relatively easy to prepare this information from the accounting records, simply by analysing all the cash coming in, and all the cash going out, into the categories shown below.

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

The following example illustrates HAJCO's Cash Flow in a format, which allows us to see if the operating activities, whilst profitable, are also, generating positive cash flows on a timely basis.

Hana Juice Company (HAJCO) Ltd.
Cash Flow Statement for the year ended December 31
(J.D. 000)

	Item (In thousands of JD)	2002	2003
[AA]	**Cash Flows From Operating Activities:**		
	Net Income	48.59	77.59
	Plus: Depreciation	21.84	24.72
	Change in Working Capital:		
	(+)/- Change in Inventories	(10.00)	(10.00)
	(+)/- Change in Accounts Receivable	(7.00)	(7.00)
	+/(-) Change in Accounts Payable	(6.46)	(6.13)
	+/(-) Change in Accrued Expenses	(5.00)	(5.00)
[AA]	**Net Cash Flows from Operating Activities**	**41.97**	**74.18**
[BB]	**Cash Flows From Investing Activities**		
	Cash Inflows:		
	Sale of Assets	-	-
	Total Cash Inflows	-	-
	Cash Outflows		
	To Capital Investments	(50.00)	(36.00)
	Total Cash Outflows	**(50.00)**	**(36.00)**
[BB]	**Net Cash Flows from Investing Activities**	**(50.00)**	**(36.00)**
[CC]	**Free Cash Flow**	**(8.03)**	**38.18**
[DD]	**Cash Flows From Financing Activities:**		
	Cash Inflows		
	From Loans	-	-
	Total Cash Inflows	-	-

Continued on the next page...

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Continued from the previous page

	Cash Outflows		
	To Loans (Prepayment)	(10.00)	(12.00)
	Total Cash Outflows	**(10.00)**	**(12.00)**
[DD]	**Net Cash Flows from Financing Activities**	**(10.00)**	**(12.00)**
[EE]	**Net Cash Flows for the Period**	**(18.03)**	**26.18**
[FF]	Cash Opening Balance	54.80	36.77
[GG]	**Cash Closing Balance**	**36.77**	**62.95**

The format is designed to distinguish clearly three elements:

- Whether the company's regular operations are generating positive cash flows, which can be used to finance investments for growth
- How much is being invested for future growth and how it is being invested
- Whether it has been necessary to resort to outside loan financing to fund any of the investment.

Discuss whether HAJCO's regular operation is generating cash. Is there a need for borrowing cash?

The elements of the Cash Flow Statement

The basic purpose of the Cash Flow Statement starts from the principle that the company's goal is to be profitable, and that the profit can be used either for distribution to the shareholders as dividends, or reinvested in the business for future growth. However, neither of these needs can be achieved until the profit is converted into available cash. It is therefore, necessary for management to understand and manage this process to ensure maximum availability of cash, particularly in a growth situation.

[AA] Net cash flow from operating activities: to what extent the period's profit has been converted into cash.

[BB] Net cash flow from investing activities: how much of the available cash has been invested in the assets needed for the planned business growth.

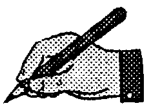
[CC] Free Cash Flow: is the amount of cash from operations remaining after the investments, if this is negative, outside financing may be needed

[DD] Cash from financing activities: as mentioned above, additional financing may be needed, this caption will give details of additional financing raised either by additional cash injected by the shareholders, or by additional financing loans. If additional Financing is systematically needed to finance cash shortages arising from operations, this is a sure sign that the company is in trouble, and certainly not able to foresee sustained growth.

[EE] Net cash flow for the period: shows the sum of the above three items which, when added to the beginning cash balance, ties to the year-end cash balance in the Balance sheet

[FF] Cash Opening Balance: shows the cash balance at the beginning of the analysis period.

[GG] Cash Closing Balance: shows the cash balance at the end of the analysis period.



EXERCISE

Ask your accountant to provide you with the most updated financial statements (Income Statement, Balance Sheet and Cash Flow Statement) and compare their presentation and contents to the ones presented in this chapter. Summarise the main differences and similarities, and the areas of development.

5. Chapter Summary

- Financial statements provide you with information on the financial status, financial performance and changes in the financial position of the business.
- The principal groups of users of a company's financial statements are those outside the company, such as tax authorities, banks, creditors, etc. and within the company, management needs detailed, regular and timely information in order to monitor and manage the performance of the business, and as a basis for sound business decisions.
- Almost all the key information required systematically by management is included in the three basic financial statements:

  a) **The BALANCE SHEET,** this document shows the financial position of the company at a given moment in time. It gives information as to all the **ASSETS** the company owns and uses in the business; all the **LIABILITIES** the company has towards other parties (i.e. the money it owes) and the difference between the two, being the **EQUITY,** the value of the owners' investment in the company. The Balance Sheet depicted as a *snapshot,* as it shows the financial position at a specific moment in time.

  b) **The INCOME STATEMENT,** shows the **REVENUES** or income derived from the company's sales of goods and services; the **COST** of making those goods or providing the services; the **EXPENSES** for operating activities, such as Selling and Administration; the **COST OF FINANCING** including, such items as interest paid and the **TAXES** to be levied on the profits. The sum of the Revenues less Costs, Expenses, Financing costs and Taxes gives the **PROFIT or LOSS** of the company. The Income statement covers the business activity over a specified period; compare it to a motion film of activity, as compared to the Balance sheet snapshot.

  c) The **CASH FLOW**: Statement (or Statement of Source and Application of Funds (a film of activity over a period). This statement highlights how much cash is generated by the normal business operations; how much of this cash becomes reinvested to enable the desired growth of the business and how much outside financing is needed to fund the investment or operating needs.

- Whilst the three financial statements are linked together by being drawn from one central accounting system and that they are interdependent, each statement serves as the source for different types of information. The **Balance sheet** showing the financial health of the company; the **Income Statement** showing the profitability of the company and its dividends and the **Cash flow** showing the sources and uses of the financial resources. This knowledge will now serve as the foundation for all of the remainder of this training manual; it is therefore, well worth spending the time and effort to grasp its main principles before continuing.

6. Make an action plan for improving your understanding of financial statements

Complete the form below to prepare your financial statements. The form in the next page titled "action plan" is useful when you prepare your financial growth plan, where you can have a master action plan for all aspects of your financial management.

You can find the forms for preparing your Action Plan in the Financial Management Growth Plan.

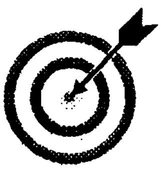
ACTION PLAN

OBJECTIVE (What to achieve?)	ACTIVITIES (What should be done?)	TIME FRAME (When it should be done?)		RESPONSIBILITY (Who should do it?)	RESOURCES (How it should be done?)	COMPLETED
		START	END			
						❑
						❑
						❑
						❑
						❑
						❑

Chapter 4

ANALYSE AND INTERPRET FINANCIAL STATEMENTS

What you will learn in this chapter ...

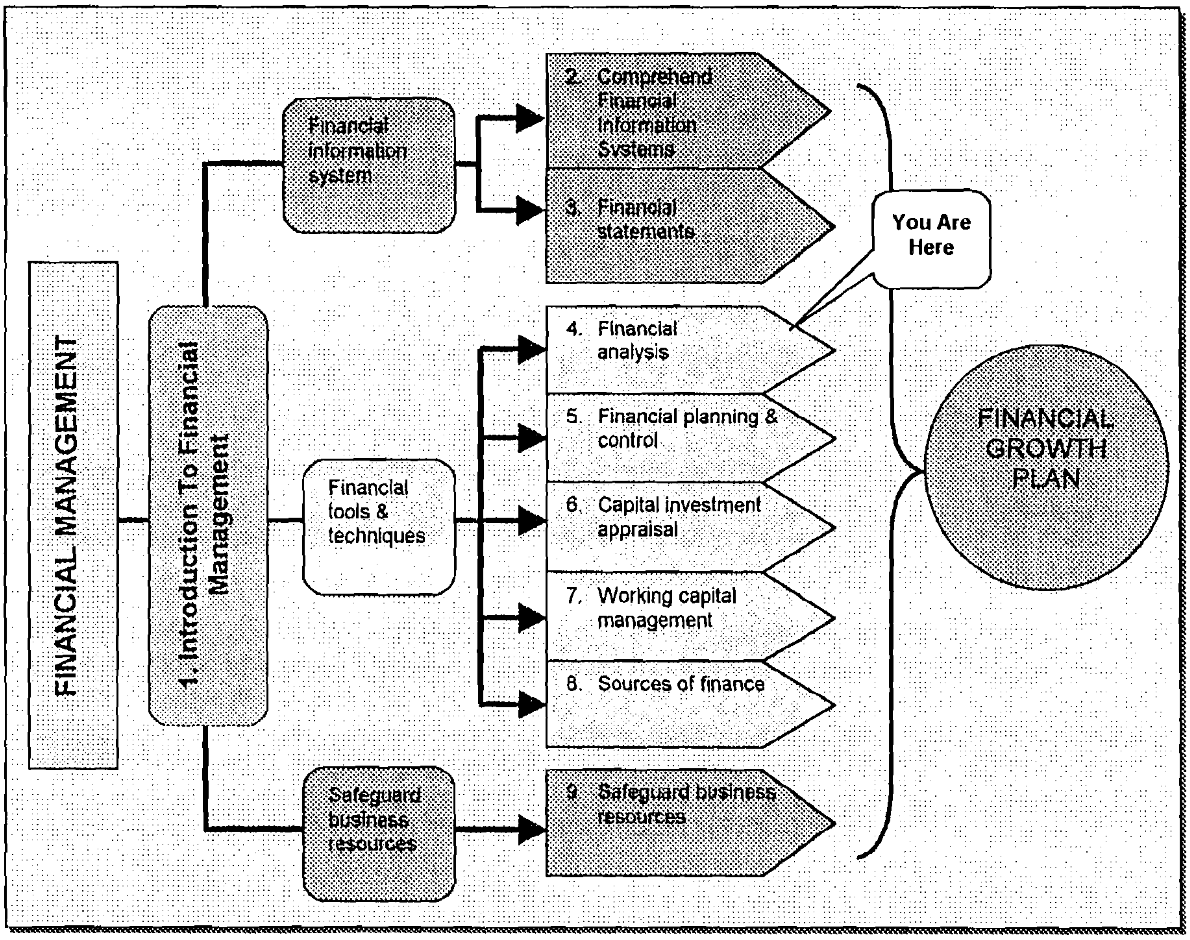


After studying this chapter, and completing the exercises in it, and with the guidance of your business trainer, you will be able to:

- **Analyse your income statement, and interpret the results.**
- **Analyse your balance sheet, and interpret the results.**
- **Analyse your cash flow statement, and interpret the results.**
- **Use the comparative analysis approach to indicate the progress of your business.**
- **Use the financial ratios to analyse your financial statements.**

Your business is growing and changes are taking place within and outside the business. You need to monitor the situation:

- Firstly, to assess how well your business is doing;
- Secondly, as a basis for making financial projections.



1. Introduction to Financial Analysis

In Chapter 3, we introduced the three basic financial statements; **Balance sheet**, **Income statement** and **Cash Flow** and saw how the information therein was essential for good management and decision-making. In this chapter, you will look at how to add a further level of understanding and use of this financial information in a more structured way using **financial ratios.**

You may go to Chapter 3 for an introduction to the three basic financial statements: Balance sheet, Income statement and Cash Flow.

Imp

You can use different techniques to analyse, and interpret your financial statements. Two of the techniques that may be used are:

- Comparative financial statements,
- Ratio analysis

What do we mean by "Financial Ratios"? The principle is that each item in the financial statements is difficult to understand and evaluate without putting it into its context. This, generally, means comparing it to another piece of information and observing the trend.

2. How analysis and interpretation of financial statements can help you to expand your business

From the analysis and interpretation of your financial statements, you are able to get a better understanding of the significance of the figures. The danger though is to want to analyse everything in every conceivable way, which can create an acute case of "*Analysis paralysis*" whereby the analysis becomes an end in itself.

The purpose of financial analysis is to identify areas needing attention, or indeed areas where performance is exceptionally good, and represents an opportunity to gain a competitive edge.

The question: Which are the most critical ratios to monitor to ensure healthy business growth? Unfortunately, there is not one simple answer, as the analytical needs will depend very much on the industry, the business structure adopted by the company and the state of maturity of the company and the general business environment.

There are nevertheless, certain critical questions we must try to answer with our analysis, which are:

- Does the company generate adequate profits in relation to the investment and the level of sales? in addition, are these profits converting quickly into liquid cash resources needed to finance the growth plan?
- Is there undue short-term risk that the company cannot pay its workers and suppliers, thus endangering its immediate existence?
- Is there undue long-term risk that the company is too reliant on borrowed funds? These will need repaying one day, and may impose an unreasonable burden of interest charges on the profits. This is particularly pertinent in developing countries with weak currencies and high interest rates and for rapidly growing companies needing additional financing.
- Is management using efficiently the assets at its disposal? Alternatively, are sloppy management practices allowing too much potential investment money being tied-up in non-productive areas?

Important

> **You may conduct financial analysis on your financial statements and on competitors (if information is available) to set up a benchmark for your performance in comparison with key competitors.**
>
> **In addition, you may find industry benchmarks for your industry to help you assess your performance better.**

3. Comparative financial statements

A simple technique of analysing financial statements involves the use of ***comparative financial statements***. This involves drawing up in tabular form, your company financial statements together with comparative figures for a selected period, say ten years, six months or, a quarter, or whatever period is required. In each case, the tabulations are useful in assessing the trends of the figures over the selected period.

> ***The comparative financial statements method*** is an easy and straightforward method of making comparisons. The distinct disadvantage however, is that the amount of the useful information that can be obtained from the comparative statements is limited.

Alternatively, you can extract key financial data from the financial statements, and present them in tabular form.

Important

Although you can draw useful information from the comparative financial statements, the size of information is still limited.

Comparative analysis may take three approaches:

- **Horizontal Analysis (Trend Analysis):** Comparing financial to denote the progress of the business by either percentages or absolute values. The trend analysis measures the change in various items from year to year by using the following equation:

$$\text{Growth (Change) Rate} = \frac{\text{(Value of the year-Value of the previous year)}}{\text{Value of the previous year}} \times 100\%$$

In the **HAJCO** case study, the net sales growth rate can be calculated as follows:

$$\text{Growth Rate in 2002} = \frac{(314-237)}{237} \times 100\% = 32\%$$

$$\text{Growth Rate in 2003} = \frac{(408-314)}{314} \times 100\% = 30\%$$

The trend analysis shows a positive trend in **HAJCO's** net sales indicates the progress of its business.

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

The following is a tabulation of the income statement of **HAJCO** for the last 3 years. Analyse the trend of **HAJCO** performance in year 2002 and 2003 by using the following Trend Analysis Form.

Item	2001	2002	2003
In thousands of JD.			
Net Sales (Turnover)	237.00	314.00	408.00
Less: Cost of Sales	110.00	152.00	196.00
Gross Profit	**127.00**	**162.00**	**212.00**
Selling and Distribution Expenses	14.00	16.00	20.00
G&A Expenses	10.00	11.00	12.00
Salaries	33.00	35.00	42.00
Bad Debts	5.00	6.00	10.00
Total Operating Expenses	**62.00**	**68.00**	**84.00**
EBITDA	**65.00**	**94.00**	**128.00**
Depreciation	10.00	21.84	24.72
Amortisation	-	-	-
EBIT	**55.00**	**72.16**	**103.28**
Interest Charges	7.00	15.00	12.00
EBT	**48.00**	**57.16**	**91.28**
Corporate Tax @15%	7.20	8.57	13.69
Net Income (Profit)	**40.80**	**48.59**	**77.59**

Trend Analysis Form

Item		2002	2003
Net Sales (Turnover)		32%	30%
Less: Cost of Sales			
Gross Profit			
Selling and Distribution Expenses			
G&A Expenses			
Salaries			
Bad Debts			
Total Operating Expenses			
EBITDA			
Depreciation			
Amortisation			

Continued on the next page...

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Continued from the previous page...

Item		2002	2003
EBIT			
Interest Charges			
EBT			
Corporate Tax @15%			
Net Income			

What are the significant trends you can observe from reading the preceding comparative financial statements?

The following is a tabulation of **HAJCO's** balance sheet for the last 3 years. Analyse the trend of **HAJCO** financial position in year 2002 and 2003

Assets	2001	2002	2003
Current Assets: Shown in thousands of JD.			
Cash on hand and at banks	54.80	36.77	62.95
Inventories	160.00	170.00	180.00
Accounts Receivable	20.00	27.00	34.00
Total Current Assets	**234.80**	**233.77**	**276.95**
Fixed Assets:			
Fixed Assets: At Cost	223.00	273.00	309.00
Less Accumulated Depreciation	17.84	39.68	64.40
Net Book Value of Fixed Assets	**205.16**	**233.32**	**244.60**
Other Assets	-	-	-
TOTAL ASSETS	**439.96**	**467.09**	**521.55**

Continued on the next page...

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Continued from the previous page...

Liabilities and Shareholders Equity: in thousands of JD.			
Current Liabilities			
Accounts Payable	129.16	122.70	116.57
Accrued Expenses	30.00	25.00	20.00
Total Current Liabilities	**159.16**	**147.70**	**136.57**
Long Term Liabilities:			
Long Term Loans	100.00	90.00	78.00
Total Long Term Liabilities	**100.00**	**90.00**	**78.00**
Shareholders Equity:			
Paid-up Capital	100.00	100.00	100.00
General Reserves	40.00	40.00	40.00
Retained Earnings	40.80	89.39	166.98
Total Shareholders' Equity	**180.80**	**229.39**	**306.98**
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	**439.96**	**467.09**	**521.55**

Trend Analysis Form

Assets		2002	2003
Current Assets:			
Cash on hand and at banks		-33%	71%
Inventories			
Accounts Receivable			
Total Current Assets			
Fixed Assets:			
Fixed Assets: At Cost			
Less Accumulated Depreciation			
Net Book Value of Fixed Assets			
Other Assets			
TOTAL ASSETS			

Continued on the next page...

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Continued from the previous page...

Liabilities and Shareholders Equity			
Current Liabilities			
Accounts Payable			
Accrued Expenses			
Total Current Liabilities			
Long Term Liabilities:			
Long Term Loans			
Total Long Term Liabilities			
Shareholders Equity:			
Paid-up Capital			
General Reserves			
Retained Earnings			
Total Shareholders' Equity			
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY			

What are the significant trends you can observe from reading the above comparative financial statements?

- **Vertical Analysis (Common Size Analysis):** Comparing the performance of various items of the financial statement in comparison with a key component of that statement. For example, comparing the performance of various income statement items compared to revenues, or comparing various items of the balance sheet in relation to total assets.

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

The following is an example of the common size analysis of HAJCO's balance sheet for the year 2001.

Assets	2001 (J.D. 000)	2001 %
Current Assets:		
Cash on hand and at banks	54.80	12%
Inventories	160.00	36%
Accounts Receivable	20.00	5%
Total Current Assets	**234.80**	**53%**
Fixed Assets:		
Fixed Assets: At Cost	223.00	51%
Less Accumulated Depreciation	17.84	4%
Net Book Value of Fixed Assets	**205.16**	**47%**
Other Assets	-	0%
TOTAL ASSETS	**439.96**	**100%**
Liabilities and Shareholders Equity		
Current Liabilities		
Accounts Payable	129.16	29%
Accrued Expenses	30.00	7%
Total Current Liabilities	**159.16**	**36%**
Long Term Liabilities:		
Long Term Loans	100.00	23%
Total Long Term Liabilities	**100.00**	**23%**
Shareholders Equity:		
Paid-up Capital	100.00	23%
General Reserves	40.00	9%
Retained Earnings	40.80	9%
Total Shareholders' Equity	**180.80**	**41%**
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	**439.96**	**100%**

Continued on the next page...

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Continued from the previous page...

The following is an example of the common size analysis of **HAJCO's** income statement for the year 2001.

Item	2001 (J.D. 000)	2001 %
Net Sales (Turnover)	237.00	100%
Less: Cost of Sales	110.00	46%
Gross Profit	**127.00**	**54%**
Selling and Distribution Expenses	14.00	6%
G&A Expenses	10.00	4%
Salaries	33.00	14%
Bad Debts	5.00	2%
Total Operating Expenses	**62.00**	**26%**
EBITDA	**65.00**	**27%**
Depreciation	10.00	4%
Amortisation	-	0%
EBIT	**55.00**	**23%**
Interest Charges	7.00	3%
EBT	**48.00**	**20%**
Corporate Tax @15%	7.20	3%
Net Income	**40.80**	**17%**

The common size analysis shows that the gross profit margin represents 54% of net sales. The total operating expenses represent 26% of net sales, of which 14% are salaries and 6% for selling and distribution expenses. Interest charges represent 3% of the net sales, which indicates the use of debt to finance **HAJCO's** operations.

By using the same **HAJCO's** income statement and balance sheet for the years 2002 and 2003, prepare the common size analysis for both years and comment on the results.

EXERCISE

1) Prepare the trend analysis of your income statement and balance sheet for the last 3 years to assess the progress of your business by time.

2) Prepare the common size analysis of your income statement and balance sheet for the last 3 years to assess the performance of the income statement items in relation to revenues, and the performance of balance sheet items in relation to total assets.

Important

You may conduct comparative analysis on annual financial statements, or on any other periodical intervals (i.e. monthly, quarterly or semi-annually). It is important to make sure that you are comparing equal intervals for each statement to come up with sound interpretations.

4. Ratio analysis

The actual changes in your financial statements from year to another can be misleading. It is important to compare them on a percentage basis to see the true picture.

A ratio is a relationship between two numbers. Financial ratios analysis uses the relationship between financial statement figures to analyse financial, and interpret financial statements. Ratio analysis is, by far, the most important and informative of the techniques used to analyse and interpret financial statements.

As with all other financial analysis techniques, ratio analysis bases itself on comparisons. You may compare your current results with past results, budgeted results, industry averages or similar firms, but whatever you do; *note* financial analysis is not done in isolation.

Financial ratios may be classified by the nature of the ratios. For instance, financial ratios are able to show themselves in these forms :

- Profitability ratios
- Liquidity ratios
- Gearing ratios
- Activity ratios
- Working capital management ratios

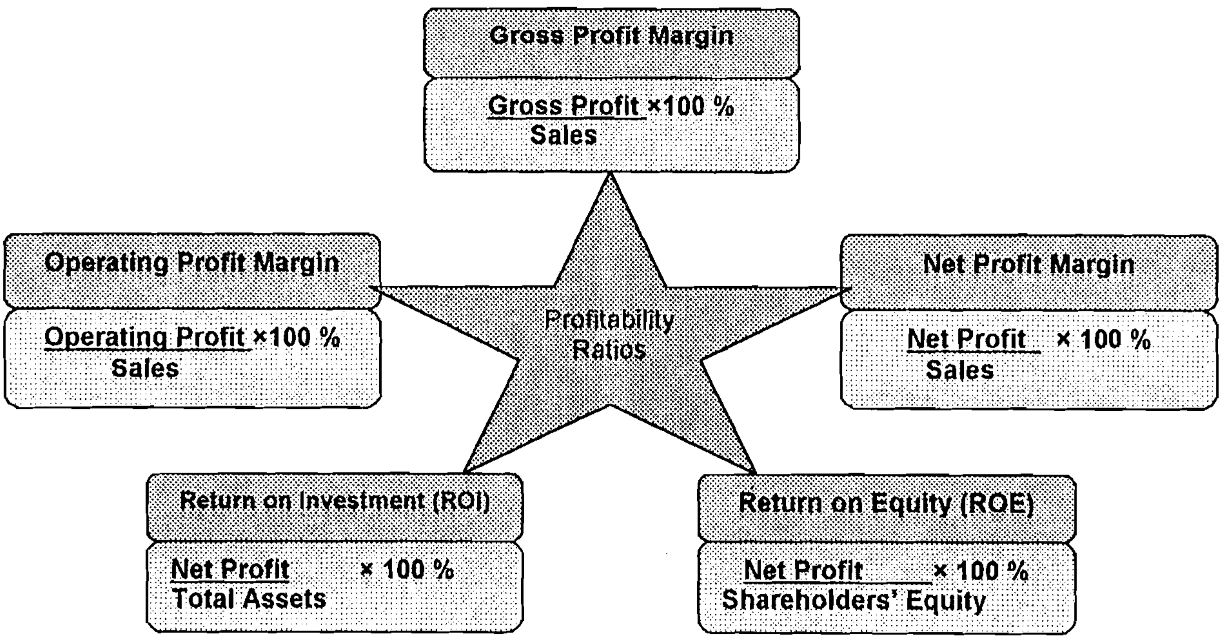
The ratio analysis will take the same classification as illustrated in the following pages.

4.1 Profitability ratios

You may not prepare all the financial statements on a monthly basis. Yet you should prepare your income statement on a monthly basis. In such a case, your monthly analysis of financial statements will emanate on the income statement.

At your financial year-end, you will need to prepare both the income statement and the balance sheet. Your financial analysis at that stage will have its basis in both statements.

Income statement ratios are concerned with the analysis of the firm's profitability. Most of the income statement ratios relate various elements of the statement to turnover.



Important

Key financial ratios based on the income statement are:

Gross profit margin, which measures the percentage of the sales value that remains to cover operating expenses, finance costs, tax expenses and required profit, after the cost of sales have been covered;

Operating profit margin, which measures the percentage of the sales value that remains as operating profit after cost of sales and operating expenses have been covered.

Net profit margin, which measures the percentage of the sales value that remains as net profit after all expenses have been covered.

Return on Equity, which measures the ability of equity to generate profits for the business.

Return on Investment, which measures the ability of total assets (invested capital) to generate profits for the business.

The ratios of net profit before tax to sales, and net profit for the year to sales, may also be calculated to determine the proportion that these profit figures constitute of turnover.

■ Gross profit margin

The gross profit that your business earns should be sufficient to cover the firm's costs and desired profits. Your firm's level of gross is, therefore, the basis for the overall profitability of the business. You may monitor the gross profit levels of your firm by calculating the gross profit to sales ratio. Alternatively the ratio can be termed as the gross profit margin. It is calculated as follows:

$$\text{Gross profit margin} = \frac{\text{Gross Profit}}{\text{Sales}} \times 100\%$$

Gross profit margins vary considerably from industry to industry. However, regardless of the industry average, it is vital that you track this ratio very closely.

Businesses that are able to maintain or expand the gross profit margin are able to generate cash to grow their businesses. However, declining gross profit margins lead to reductions of cash and can erode the overall profitability of the business.

A decline in the gross profit margin could result from:

- Rising cost of sales that can not be matched by selling price adjustments;
- Poor pricing policies.

Different types of businesses aim for different profit margins. High turnover merchandising businesses often pursue a strategy of low profit margins and high sales volumes. Firms with heavy capital investments, such as manufacturing, mining and heavy engineering firms may follow a high profitability – relatively low turnover strategy. Your business should aim to maintain your target gross profit margin for your particular sales volume.

- **Operating profit margin**

Operating profit is a key measure of the profitability of a firm. The operating profit margin measures the proportion of sales that operating profit constitutes. The ratio calculates as follows:

$$\text{Operating profit margin} = \frac{\text{Operating profit}}{\text{Sales}} \times 100\%$$

Operating profit is the proportion of the sales value that remains after cost of sales and operating expenses have been covered.

- **Net profit margin**

The net profit margin measures the capacity of the business to generate profits from operating and non-operating activities. The ratio calculates as follows:

$$\text{Net profit margin} = \frac{\text{Net profit}}{\text{Sales}} \times 100\%$$

- **Return on Investment (ROI)**

The measurement of profitability using income statement ratios only tells part of the profitability story. Profitability is better measured by calculating the return or profits earned on the investment made in the firm. A ratio that may be used to measure this is the return on investment. The return on investment is calculated as follows:

$$\text{Return on investment} = \frac{\text{Net Income}}{\text{Total assets}} \times 100\%$$

The return on investment of a firm is determined by two factors:

a) The proportion of the sales value that goes towards profit, as measured by the **net income to sales ratio**; and

b) The ability of the firm to use the assets at its disposal to generate sales, as measured by the **sales to total assets ratio**.

■ Return on Equity (ROE)

The return on equity measures the capacity of shareholders equity to generate net profit. The return on equity is calculated as follows:

$$\text{Return on equity} = \frac{\text{Net Income}}{\text{Shareholders Equity}} \times 100\%$$

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Profitability Ratios

The following table shows the profitability ratios of **HAJCO** for year 2000. Write the equation for each ratio and calculate the ratios, for years 2002-2003, and comment on them to reflect your conclusions based on the analysis

Item	Unit	Equation	2001	2002	2003
Profitability Ratios					
Gross Profit Margin	%		53.6%		
Operating Profit Margin	%		23.2%		
Net Profit Margin	%		17.2%		
Return on Investments (ROI)	%		9.3%		
Return on Equity (ROE)	%		22.6%		

Analysis Findings:

1. Describe the trend in the ratio, and illustrate the reasons behind the trend.

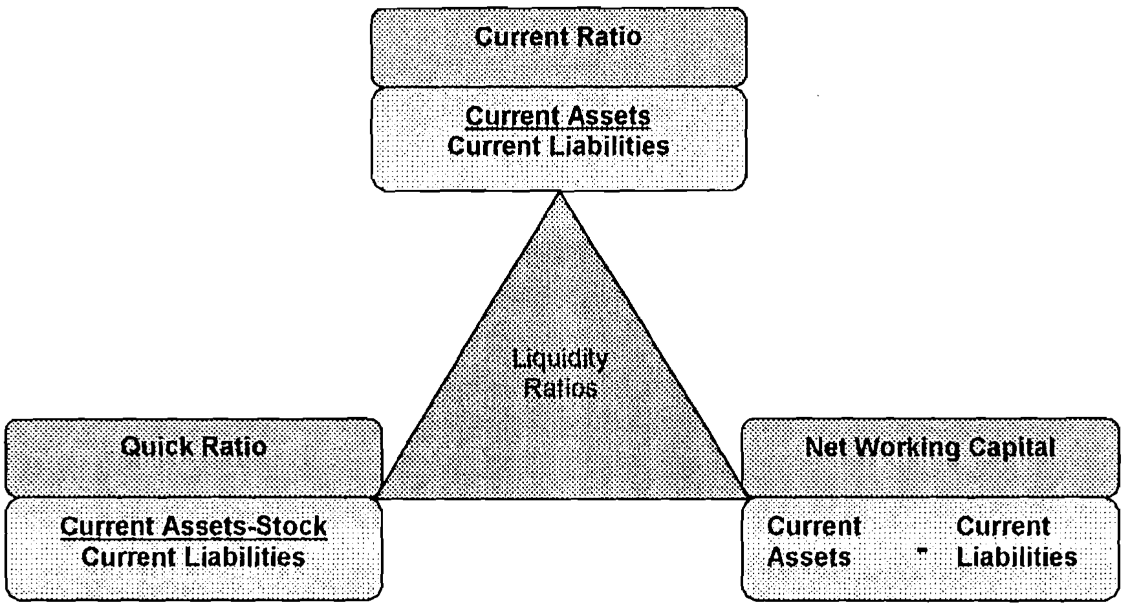
2. Analyse profitability performance results, and how to improve them

4.2 Liquidity ratios

Two principal ratios are used to assess the liquidity of a firm. These are:

- The current ratio.
- The quick ratio.
- Working capital.

The liquidity ratios can be calculated from the balance sheet, which shows the financial position of the firm. It is useful to use the ratio analysis technique on your balance sheet in order to assess and continuously monitor your firm's financial position.



The firm's liquidity is the firm's ability to meet its short term obligations as they fall due,

- **Current ratio**

The current ratio, alternatively known as the working capital ratio, is used to measure the net working capital position or short-term liquidity of the firm.

The current ratio formula is calculated thus:

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

The ratio helps to answer the question, 'How quickly can the business liquidate short-term assets to pay off short-term debts?' If your business is growing quickly, this ratio can help provide you with early warning signs of impending cash shortages. Where the business prepares a balance sheet on a monthly basis, or otherwise calculates, on a monthly basis, the total amounts of current assets and current liabilities, it can use the ratio to monitor liquidity on a monthly basis.

- **Quick ratio**

The quick ratio, also known as the '*acid-test*' ratio, measures the immediate liquidity of the firm. The quick ratio is calculated as follows

$$\textbf{Quick ratio} = \frac{\textbf{Liquid Assets (current assets less stock)}}{\textbf{Current liabilities}}$$

The ratio gives an indication of the extent to which cash or near cash assets cover current liabilities. This ratio is a very sensitive measurement of cash flow and helps a business predict cash flow shortages.

- **Net Working Capital**

The strict definition of net working capital is current assets less current liabilities equal net working capital. In practical terms, working capital is the money that funds the daily operations of the business. Shortages of working capital can cause serious interruptions in the business operations. Severe shortages may cause you to withhold payment from suppliers, or even to have trouble-making payroll. It remains is extremely important to track your working capital.

Net Working Capital = Current Assets – Current Liabilities

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Liquidity Ratios

The following table shows the liquidity ratios of **HAJCO** for year 2001. Write the equation for each ratio, and calculate the ratios for years 2002-2003, and comment on them to reflect your conclusions based on the analysis

Item	Unit	Equation	2001	2002	2003
Liquidity Ratios					
Current Ratio	Times		1.48		
Quick Ratio	Times		0.47		
Working capital	000 JD		75.64		

Continued on the next page...

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Continued from the previous page...

Analysis Findings:

1. Describe the trend in the ratio, and illustrate the reasons behind the trend.
2. Analyse liquidity position results, and show how to improve them.

4.3 Gearing ratios

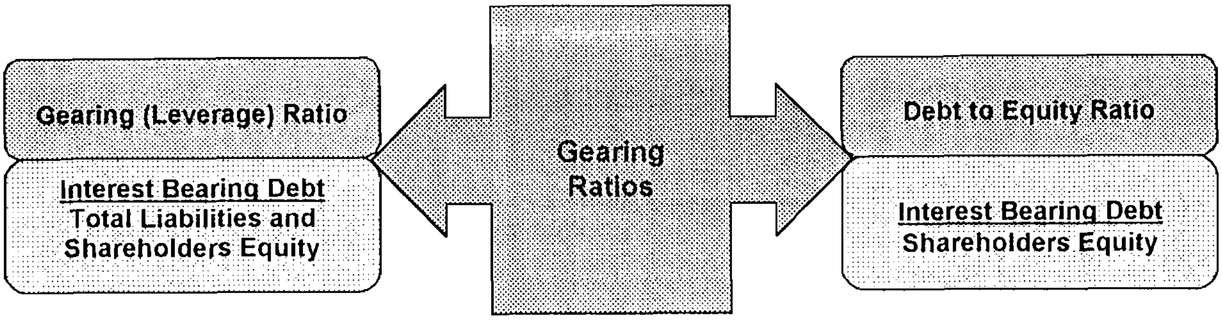
Gearing or capital structure ratios measure the composition of the capital used to finance the business. The focus of the gearing ratios is to measure the extent to which the firm uses debt in its capital structure. The use of debt may represent both an opportunity and risk to the firm. The use of debt capital may present a turn with an opportunity to increase the earnings attributable to shareholders by using borrowed capital, on which fixed interest is paid, to earn operation profits in excess of the fixed interest. The excess of the operating profits earned on borrowed capital, and the fixed interest paid to lenders accrue to shareholders. The use of debt in a firm's capital structure may represent a risk. If a firm fails to earn from the borrowed capital, enough operating profit, it will still be required to meet its interest obligation. In any such cases, the shortfall is met by the shareholders, whose earnings will be correspondingly reduced.

Important

The firm's capital structure is the composition of the firm's sources of capital.

The principal gearing ratios are:

- The gearing (leverage) ratio
- The debt to equity ratio



■ Gearing (leverage) ratio

The gearing ratio measures the proportion of non-current debt capital in the capital structure of the firm. This ratio is calculated as follows:

$$\text{Gearing ratio} = \frac{\text{Interest bearing debt (loans)+Liabilities}}{\text{Total Liabilities and Shareholders Equity}}$$

■ Debt to equity ratio

Debt to equity ratio measures the extent of debt financing from the gearing ratio. The ratio expresses non-current debt as a ratio of equity. More specifically, this ratio is calculated as follows:

$$\text{Debt to equity ratio} = \frac{\text{Interest bearing debt (loans)+Liabilities}}{\text{Shareholders equity}}$$

Certain capital structure ratios may be so low, that they represent missed opportunities of using debt to earn profit for the shareholders. Other ratios are so high, that they expose the business to the risk of failing to meet its debt serving commitments. In such an event, the firm will be forced into liquidation. In between these two extremes, the appropriate capital structure for your business depends on the risk inherent in the nature of your business, the specific conditions of your business and the economic environment.

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Gearing (Leverage) Ratios

The following table shows the gearing ratios of **HAJCO** for year 2001. Write the equation for each ratio, and calculate the ratios for years 2002-2003, and comment on them to reflect your conclusions based on the analysis

Item	Unit	Equation	2001	2002	2003
Gearing Ratios					
Gearing Ratio	%		58.9%		
Debt to Equity Ratio	%		143.3%		

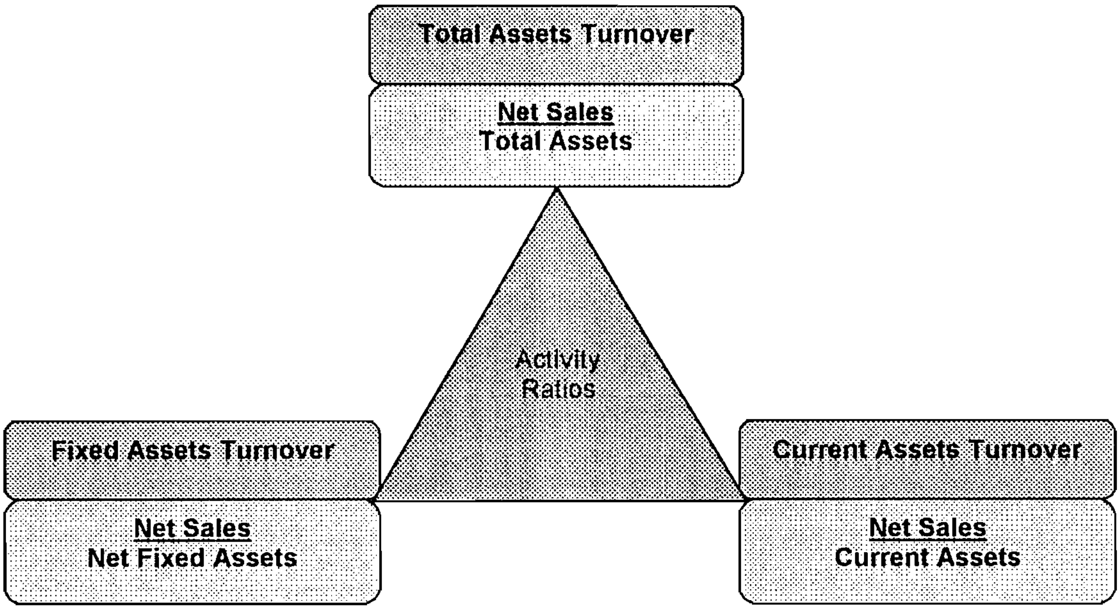
Analysis Findings:

1. Describe the trend in the ratio, and illustrate the reasons behind the trend.
2. Analyse capital structure results, and show how to improve them.

4.4 Activity ratios

The principal activity ratios are:

- Total assets turnover ratio
- Fixed assets turnover ratios
- Current assets turnover ratios



■ Total asset turnover ratio

The total asset turnover ratio ensures the efficiency with which the firm is using the assets at its disposal to generate sales.

These ratios are calculated as follows:

$$\text{Total asset turnover ratio} = \frac{\text{Sales}}{\text{Total assets}} \text{ times}$$

The trends in the total asset turnover ratio may be explained by further analysing efficiency in asset management using

- fixed asset turnover ratio
- Current asset turnover ratio.

■ Fixed and current assets turnover ratios

The ratios measure the efficiency with which the firm is using the fixed assets and current assets, respectively, to generate sales.

These ratios are calculated as follows:

$$\text{Fixed asset turnover ratio} = \frac{\text{Sales}}{\text{Fixed assets}} \text{ times}$$

$$\text{Current asset turnover ratio} = \frac{\text{Sales}}{\text{Current assets}} \text{ times}$$

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Activity Ratios

The following table shows the activity ratios of **HAJCO** for year 2001. Write the equation for each ratio, and calculate the ratios for years 2002-2003, and comment on them to reflect your conclusions based on the analysis

Item	Unit	Equation	2001	2002	2003
Activity Ratios					
Total Assets Turnover	Times		0.54		
Fixed Assets Turnover	Times		1.16		
Current Assets Turnover	Times		1.01		

Analysis Findings:

1. Describe the trend in the ratio, and illustrate the reasons behind the trend.
2. Analyse activity results, and show how to improve them.

4.5 Working capital management ratios

The trends in the current asset turnover ratio measure the efficiency with which current assets are used to generate sales. The ratio gives an indication of whether the firm's investment in current assets is commensurate with its level of activity. Working capital management ratios measure this aspect in detail.

Working capital ratios include:

- Inventory turns
- Days sales outstanding (DSO)

■ Inventory turns

Efficiency in the management of inventory may be measured using the inventory turns ratio (how many times does inventory turn each year).

This ratio is calculated as follows:

$$\text{Inventory turns} = \frac{\text{Cost of sales}}{\text{Ending Inventory}}$$

A balance must be struck between quickly turning over the inventory, and in the process earning profit on one hand, and ensuring that there is sufficient inventory on hand to meet customer demands on the other. Quick turn of inventory is good for profits, but holding too little inventory and running short of goods may send customers looking elsewhere.

- **Days sales outstanding (DSO)**

  This ratio reflects the average time to collect invoiced amounts from customers, which indicates collection practices in the business.

This ratio is calculated as follows:

$$\text{Days sales outstanding} = \frac{\text{Accounts receivable}}{\text{Net sale}} \times 365$$

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

The following income statement contains a column for income statement ratios. Calculate the ratios, and comment on them to reflect your conclusions based on the analysis

Item	Unit	Equation	2001	2002	2003
Working Capital Management					
Inventory Turns	Times		0.69		
Days Sale Outstanding (DSO)	Days		30.80		

Analysis Findings:

1. Describe the trend in the ratio, and illustrate the reasons behind the trend.
2. Analyse working capital management results, and show how to improve them.

EXERCISE

Use your financial statements for the last 3 years for calculating your financial ratios in the following table. If you face any difficulty, consult your trainer to give guidance.

Item	Unit	Equation	2001	2002	2003
Profitability Ratios					
Gross Profit Margin	%				
Operating Profit Margin	%				
Net Profit Margin	%				
Return on Investments (ROI)	%				
Return on Equity (ROE)	%				
Liquidity Ratios					
Current Ratio	Times				
Quick Ratio	Times				
Working capital	000 JD				
Leverage Ratios					
Leverage Ratio	%				
Debt to Equity Ratio	%				
Activity Ratios					
Total Assets Turnover	Times				
Fixed Assets Turnover	Times				
Current Assets Turnover	Times				
Working Capital Management					
Inventory Turns	Times				
Days Sale Outstanding (DSO)	Days				

5. Chapter Summary

Financial Analysis is a series of tools, which we call Financial Ratios, and which allow us to take the information from the financial statements we studied in Chapter 3, and add a further level of understanding by relating individual items in the statement to other items to give them context and meaning.

We examined Financial Ratios to understand better:

- If the company is profitable in relation to the shareholders' investment and the level of sales, and are these profits, converting quickly into liquid cash resources needed to finance the growth plan: The **Profitability Ratios.**

- If there is short-term risk that the company cannot pay its workers and suppliers – The **Liquidity Ratios.**
- If there is long-term risk that the company is too reliant on borrowed Funds, and has high level of liabilities – The **Gearing Ratios.**
- If management is using efficiently the assets at its disposal, or are sloppy management practices allowing potential investment, money to be tied-up in non-productive areas- **Activity Ratios.**
- If there is proper management of the working capital – The **Working Capital Management Ratios.**

So far, we have used these ratio tools to understand the financial statements, and to identify potential strengths and weaknesses in your company to prepare corrective actions where necessary. You also noted that the ratios are a good tool for understanding trends in the areas under scrutiny, which way is your company going? It is, also easy to envisage that these ratios can be used to compare your own company with competitors and similar companies to see where they are more or less effective.

In the next chapter, you will also see how these ratio tools are useful in business planning and goal setting for performance measurement.

6. Make an action plan for improving your analysing your financial statements

Complete the form below to prepare your plan for analysing your financial statements. The action plan show in the next page is useful when you prepare your financial growth plan, where you can have a master action plan for all aspects of your financial management.

You can find the forms for preparing your Action Plan in the Financial Management Growth Plan.

ACTION PLAN

OBJECTIVE (What to achieve?)	ACTIVITIES (What should be done?)	TIME FRAME (When it should be done?)		RESPONSIBILITY (Who should do it?)	RESOURCES (How it should be done?)	COMPLETED
		START	END			
						❑
						❑
						❑
						❑
						❑
						❑

Chapter

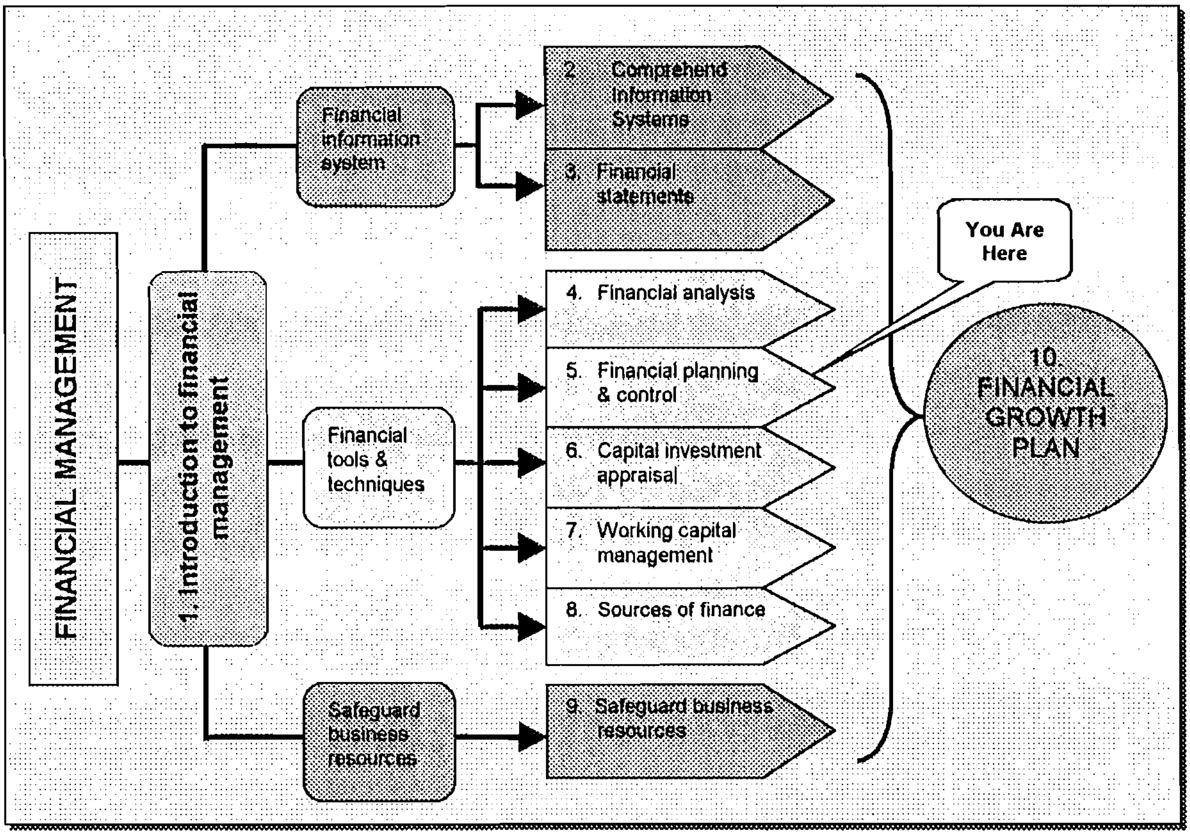
5

PLAN AND CONTROL YOUR FINANCE

What you will learn in this chapter ...

After studying this chapter and completing the exercises in it, and with the guidance of your business trainer, you will be able to:

- **Identify the role and importance of financial planning and control in growing your business.**
- **Use financial planning and control concepts and techniques to grow your business.**
- **Prepare budget for your operations**



1. What is financial planning and control

Financial planning involves quantifying in financial terms, the way in which the business intends to achieve its objectives.

Financial control refers to how the business ensures that its performance is in line with its plan.

To ensure that your organisation achieves its financial objectives you need to use a financial and planning and control system to;

- Translate the functional plans of your enterprises into financial plans.
- Compare actual results with the financial plans, and
- Where variations exist, take appropriate control action

A critical component of financial planning and control is the analysis of any variances between your financial plans and actual results of your business activities. If the variance is negative, you should be able to identify the causes and plan corrective actions to bring your business back to plan as soon as possible. If the variances are positive, you should also understand them and revise the plans upwards if there are sustainable additional opportunities.

Financial planning takes place within the context of the overall business planning process. It is part of an integrated process, which incorporates the following major elements:

- **Strategic plan**; sets overall goals for the business as outlined in the Strategic Management module
- **Annual *budget***; takes the first year of the Strategic plan and breaks it down into the specific elements which need to be planned and quantified in detail to ensure they achieve the year's targeted goals of growth and profitability. The annual budget will include two principal sections namely;

> *A **budget** is a quantitative expression of a short-term plan of action.*

  - **The operating budget**, which consists of the budgeted income statement and its supporting budgets.
  - **The financial budget**, which consists of the budgeted balance sheet and such supporting budgets as the cash and capital budgets as well as the budgeted cash flow statement.

These plans will be summarised into the formats of the Income statement, Balance Sheet and Cash Flow statement we saw in Chapter 4. You will then need to assign responsibilities for each section of the budget, which you will use to measure the performance of each part of your organization.

In this way, you will ensure that all parts of your organization are working towards the common goals as laid out in the Strategic plan and you will be able to reward employees fairly based on their contributions to achieving these goals.

2. How financial planning and control can help your business to grow

Used correctly, financial planning and control will help you to derive the following advantages:

- You will ensure that your underlying operating plans are feasible and that they take your business in the direction of your long –term goals.
- You will be able to allocate your resources efficiently.
- Budgetary planning helps you to co-ordinate the activities of the various functions of the business.
- Budgets help you to foster the communication process within the business.
- Budgetary planning and control can improve commitment and motivation, particularly if the process involves participation by those who will be affected.
- Budgets help the managers to stay in control of the operations.
- Budgets provide a basis for delegating responsibility to line managers. These managers are then required to operate within the parameters of the budgets.
- Budgets provide a basis for rewarding managers and employees based on their performance (compared to budgets).

3. Financial Planning Tools

3.1 The Strategic Finance Plan

The first step in the financial planning process is to build the link from the high-level goals in the Strategic plan to the more detailed Finance section of the strategic plan. If we take the example of **HAJCO**, we see that the Strategic plan defines the following objectives:

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Profitability:

Mission statement:

Goal: The business aims at high profit generation in the long run which will be reinvested largely for business growth.

Long-term objectives:

1. Increase profit margin by a minimum of 2% each year
2. Return on Equity kept at attractive minimum of 25% yearly
3. Reinvest a minimum of 50% of profits earned.

Functional and shorter term objectives

1. Profit margin to be increased from current 19% to 21% by the end of the next year
2. Return on Equity to be raised from current 25% to 26% by the end of the next year
3. Reinvestment aimed at 100% for next year.

Competitive Position:

Mission Statement:

Goal: To become the largest local producer, expand current production into new markets and develop new products.

Continued on the next page...

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Continued from the previous page...

Long term objectives:

1. A growth of sales turnover of 25% per year
2. Fruit juice has entered new local markets within planning period and achieved higher market share in current market.
3. Shift target market segmentation from tourism to local markets within planning period.

Functional and shorter term objectives:

1. Sales growth of 25 % in next 12 months
2. First development phase of jams, jellies and chutney completed by end of next year.

Physical and Financial Resources

Mission Statement:

Goal: To establish financial stability through increased ownership of property and prudent financial management.

Long-term objectives:

1. Own currently rented factory outlet within 3 years
2. Adequate working capital system, budgeting system, and financial performance monitoring system set-up within plan period.

Functional and shorter term objectives:

1. Current factory lease contract converted to purchase contract within next 3 months
2. Finance manager recruited within next 6 months. Financial information and reporting system developed within 12 months.

Mr. Jameel realises that these high-level visionary goals and objectives need to be translated into something much more tangible to be able to manage the next stages of the growth of his business. Ideally, he would have liked to recruit a new finance manager immediately to help do this, but he realises that this could take a few weeks or months, so he hires, as a consultant, a retired colleague from his old company, Mr. Saber, who was responsible for the business planning process. He asks his old colleague for help in:

- Translating the strategic directional statements into a three-year plan to indicate the size of the challenge and identify the major investments necessary to achieve the defined goals.
- Once the above is prepared and agreed, preparing the detailed operational budget for the first year.
- Hiring a suitable finance manager as soon as possible to implement the computerized accounting system and track performance against the budget.

Continued on the next page...

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Continued from the previous page...

Mr. Saber explains to Mr. Jameel that they need to identify the major items of financial information to project over the coming three years, then make the projections from the trends shown by the 2001-2003 information already available (see Chapter 4 and the goals defined in the strategic plan. From this, a number of major decisions will emerge and these will need to be identified, appropriately quantified and fitted into the three-year plan. Based on discussions with Mr. Jameel, Mr. Saber identifies the following parameters as critical for quantifying in the three-year plan:

1. Amount of sales growth, with some idea of volume growth, as opposed to price and new product introductions.
2. The capacity to maintain at the present level or to improve the cost of sales as a percentage of sales. With the planned sales growth, this will include consideration of:
   a. Additional building costs and equipment depreciation
   b. Additional production-line workers
   c. Additional production infrastructure
   d. Changes in the costs of raw materials
3. The need to grow the selling, management and administrative infrastructure to cope with the business growth.
4. The need to invest in new factory, distribution and office equipment

Using his previous experience, Mr. Saber evaluates the future and proposes the following projections (see also tables on the next pages):

Projections used to prepare projected Income Statements

1. **Revenue growth,** 25% per year, as per long-term plan.

   This will be achieved through new hotel customers, but also by opening the distributor channel to sell to supermarkets and later, developing the export market.

2. **Cost of Sales and Gross margin,** Normally the gross margin should improve, as economies of scale are achievable in the factory with the volume growth. However, the sales to distributors will have a lower margin than the direct hotel sales, so the goal is to maintain the margin at the current level.
3. **Operating expenses,** these must be managed to a growth rate below sales to ensure the 2% per year net profit on sales (RoS) percentage increase, per the strategic plan. Individual categories of operating expenses are projected to increase as follows;

   a. **Selling and distribution expenses**: Normally the combination of
      - selling and distribution costs and,
      - the lower selling prices

      associated with sales to distributors would be expected to result in higher selling and distribution expense to sales percentages. However, these costs will be managed at the current percentage levels during the plan period.

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Hana Juice Company (HAJCO) Ltd.

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b. **General and administration expenses (G&A):** The development and operation of a new financial and reporting system will increase the administrative costs related to the system, but help to effectively control the other costs. The net effect is that G&A expenses are expected to grow by 16,67 % in the first year of the plan period and there after by an average of 15% per annum.

c. **Salaries:** Despite the improved cost control resulting from the planned introduction of a new financial monitoring and control system the recruitment associated with the growth in the selling, management and administrative infrastructure is projected to increase salaries by 16% in the first year of the plan period and thereafter by an average of 15% per annum.

d. **Bad Debts:** The introduction of an effective working capital management system, including a credit control system will reduce the incidence of bad debts on existing customers. However the increase in the projected growth in the proportion of sales to non – hotel customers will increase the percentage of bad debts to sales. The bad debts to sales percentage are expected to rise marginally from the current 2,45% to 2,47, then 2,54 before dropping to 1,96.

4. **Depreciation:** Changes in the projected depreciation expense is affected by changes in fixed assets. Capital expenditure and the resultant fixed asset and depreciation levels are as follows.

	2003 JD 000	2004 JD 000	2005 JD 000	2006 JD 000
Opening balance of fixed assets	309.00	352.00	375.00	
Additions	43.00	23.00	50.00	
Closing Balance	352.00	375.00	425.00	
Annual Depreciated expense at a blended Rate of 8%	24.72	28.1	30.00	34.00

5. **Interest charges:** Projected interest charges are based on projected long-term loans (see projected cash flow statement below). For the plan period the projected balances and repayments are as follows)

	2003 JD 000	2004 JD 000	2005 JD 000	2006 JD 000
Opening balance	90.00	78.00	68.00	59.00
Repayment for the year	(12.00)	(10.00)	(9.00)	(7.00)
Closing Balance	78.00	68.00	59.00	52.00
Interest calculated at the rate of $13^{1/3}$ % on opening balance	12.0	10.40	9.07	7.87

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Hana Juice Company (HAJCO) Ltd.

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6. **Corporate tax:** A tax rate of 15% of earnings before tax (EBT) is assumed to apply to the whole planning period
7. **Net profit,** because of the above; the firm will achieve the two percent point per year increase in net profit to sales percentage targeted in the strategic plan. It is assumed that this will all be reinvested during this high growth period.

   The following table shows the projected income statements of HAJCO for the plan period

Item	2003	2004	2005	2006
	(JD 000)	(JD 000)	(JD 000)	(JD 000)
Net Sales (Turnover)	408.00	510.00	637.50	796,88
Less: Cost of Sales	196.00	245.00	306.25	382.81
Gross Profit	**212.00**	**265.00**	**331.25**	**414.07**
Selling and Distribution Expenses	20.00	25.00	31.25	39.06
G&A Expenses	12.00	14.00	16.10	18.52
Salaries	42.00	48.72	56.03	65.43
Bad Debts	10.00	12.61	16.18	15.65
Total Operating Expenses	**84**	**100.33**	**119.56**	**138.66**
EBITDA	**128.00**	**164,67**	**211.69**	**275.41**
Depreciation	24.72	28.16	30.00	34.00
Amortization	-	-	-	-
EBIT	**103.28**	**136.51**	**181.69**	**241.41**
Interest Charges	12.00	10.40	9.07	7.87
EBT	**91.28**	**126.11**	**172.62**	**233.54**
Corporate Tax @15%	13.69	18.92	25.89	35.18
Net Income	**77.59**	**107.19**	**146.73**	**198.36**

Projections used to prepare projected balance sheets

1. **Current Assets:** The projections for current assets balances are calculated on the following bases;

   a. **Cash on hand and at banks:** based on the projected cash flow statements (see projected cash flow statements below)

   b. **Inventories and accounts receivable:** based on working capital policies (see working Capital management, chapter 7)

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CASE STUDY

Hana Juice Company (HAJCO) Ltd.

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2. **Fixed Assets** (Capital Investment); projected levels of fixed assets are based on plans to acquire land, build new factory, and computerise the accounting system as well as the need for more equipment and delivery vehicles to support the growth. There will be corresponding changes to the accumulated depreciation
3. **Current Liabilities:** As with current assets, Projected current liability balances are based on working capital management policies (see working capital management, chapter 7)
4. **Long-term liabilities:** Projected long-term loan balances are based on projected financing requirements/loan repayments determined in the projected cash flow statements (see projected cash flow statements below).
5. **Shareholders Equity:** There are no projected changes in paid up capital and General Reserve. Retained earnings are projected to increase by the amounts of annual net income that will be retained.

The following table shows the projected balance sheets of HAJCO for the plan period.

Three Year Projected balance sheets				
Current Assets:	**2003**	**2004**	**2005**	**2006**
	(JD 000)	(JD 000)	(JD 000)	(JD 000)
Cash on hand and at banks	62.95	74.47	186.66	333.76
Inventories	180.00	190.00	200.00	210.00
Accounts Receivable	34.00	84.00	96.00	105.00
Total Current Assets	**276.95**	**348.47**	**482.66**	**648.76**
Fixed Assets:				
Fixed Assets: At Cost	309.00	352.00	375.00	425.00
Less Accumulated Depreciation	(64.40)	(92.56)	(122.56)	(156.56)
Net Book Value of Fixed Assets	**244.60**	**259.44**	**252.44**	**268.44**
Other Assets	-	-	-	-
TOTAL ASSETS	**521.55**	**607.91**	**735.10**	**917.20**

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Hana Juice Company (HAJCO) Ltd.

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Liabilities and Shareholders Equity	2003	2004	2005	2006
Current Liabilities				
Accounts Payable	116.57	110.74	105.20	99.94
Accrued Expenses	20.00	15.00	10.00	5.00
Total Current Liabilities	**136.57**	**125.74**	**115.20**	**104.94**
Long Term Liabilities:				
Long Term Loans	78.00	68.00	59.00	52.00
Total Long Term Liabilities	**78.00**	**68.00**	**59.00**	**52.00**
Shareholders Equity:				
Paid-up Capital	100.00	100.00	100.00	100.00
General Reserves	40.00	40.00	40.00	40.00
Retained Earnings	166.98	274.17	420.90	620.26
Total Shareholders' Equity	**306.98**	**414.17**	**560.90**	**760.26**
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY	**521.55**	**607.91**	**735.10**	**917.20**

Projections used to prepare projected cash flow statements:

The projections of cash flow statements are largely based on projected income statements and projected balance sheets as follows;

1) **Cash flows from Operating Activities:** Projected cash flows from operating activities are based on the analysis of projections of relevant income statement and balance sheet items.

2) **Cash flows from investing activities:** Projections for capital expenditure investments are as tabulated under the basis for depreciation projections above.

3) **Cash flow from Financing Activities:** Projections for increases or repayment of loans are based on opening balances and projected free cash flows for the plan periods.

The following table shows the budgeted cash flow statement of HAJCO for the plan period.

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CASE STUDY

Hana Juice Company (HAJCO) Ltd.

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Three Year Projected Cash Flow Statements

Item	2003	2004	2005	2006
	(JD 000)	(JD 000)	(JD 000)	(JD 000)
Cash Flows From Operating Activities				
Net Income	103.28	136.51	181.69	242.41
Plus Depreciation	24.72	28.16	30.00	34.00
Bad debts write offs	10.00	12.61	16.18	15.65
Change in Working Capital:				
(+)/- Change in Inventories	(10.00)	(10.00)	(10.00)	(10.00)
(+)/- Change in Accounts Receivable	(17.00)	(62.61)	(28.18)	(24.65
+/(-) Change in Accounts Payable	(6.13)	(5.83)	(5.54)	(5.26)
+/(-) Change in Accrued Expenses	(5.00)	(5.00)	(5.00)	(5.00)
Cash generated from operations	**99.87**	**93.84**	**179.15**	**247.15**
Finance costs	(12.00)	(10.40)	(9.07)	(7.87)
Tax payments	(13.69)	(18.92)	(25.89)	(35.18)
Net Cash Flow From Operating Activities	74.18	64.52	144.19	204.10
Cash Flows From Investing Activities				
Sale of Assets	-	-	-	-
Acquisition of Fixed Assets	(36.00)	(43.00)	(23.00)	(50.00)
Net Cash Flows from Investing Activities	**(36.00)**	**(43.00)**	**(23.00)**	**(50.00)**
Free Cash Flow	**38.18**	**21.52**	**121.19**	**154.10**
Cash Flows From Financing Activities				
Increase in loans	-	-	-	
Loans Repayments	(12.00)	(10.00)	(9.00)	(7.00)
Net Cash Flows from Financing Activities	**(12.00)**	**(10.00)**	**(9.00)**	**(7.00)**
Net Cash Flows for the Period	**26.18**	**11.52**	**112.19**	**147.10**
Cash Opening Balance	36.77	62.95	74.47	186.66
Cash Closing Balance (Cumulative Cash Flow)	**62.95**	**74.47**	**186.66**	**333.76**

3.2 The annual budget

The main short-term financial planning and control tool available to your business is budgetary planning and control. The annual budget of your business is a financial expression of your business' operational plan for the current year. Budgetary planning and control involves establishing the annual budget and using it in running the day-to-day affairs of the business. Some budgets such as capital expenditure budgets may contribute towards the achievement of both short-term and medium to long term objectives. In a large corporation, this involves many departments and managers and can take many months to prepare. In the cases of smaller business such as **HAJCO,** or your own, the effort should be proportional to the size and complexity of the business. **For HAJCO**, probably only Mr. Jameel, his wife and his financial advisor will be involved at this stage. The budget serves mostly to help them plan what they need to do and to follow on how well it is happening.

The use of budgets involves two main phases:

- The budgetary planning phase,
- The budgetary control phase.

3.2.1 Budgetary Planning Phase

At the budgetary planning phase, you compile the various budgets that make up your suit of budgets. These include the budgeted income statement, the budgeted balance sheet, and the budgeted cash flow statement.

You need to plan for what you want from your business. You use a budgeted income statement format to plan for the financial results you want to see at the end of your budget period. The budgeted income statement and its supporting budgets are referred to as the operating budget.

In the case of the budgeted Income Statement, budgetary planning involves:

a) Establishing planning parameters, including the expected conditions during the planning period as well as the goals and structure established in the Strategic finance plan discussed above.

b) The preparation of budget segments for sales, production, administration costs, selling and distribution costs

c) The combination and co-ordination of the individual segments of the budget and checking whether they are feasible and well integrated.

d) Production of the final budget.

You use a budgeted balance sheet format (or extracts from it) to plan for the financial position you want for your business at the end of the budget period. In reality, companies tend to plan only the critical operating assets and liabilities such as cash (see also cash budget), accounts receivable and payable, inventories and fixed assets. (See Capital Budget)

You use a capital budget to plan for the acquisition of plant and equipment required to meet the revenue and functional goals of your business. The Capital Budget helps in understanding the financing needs of your business.

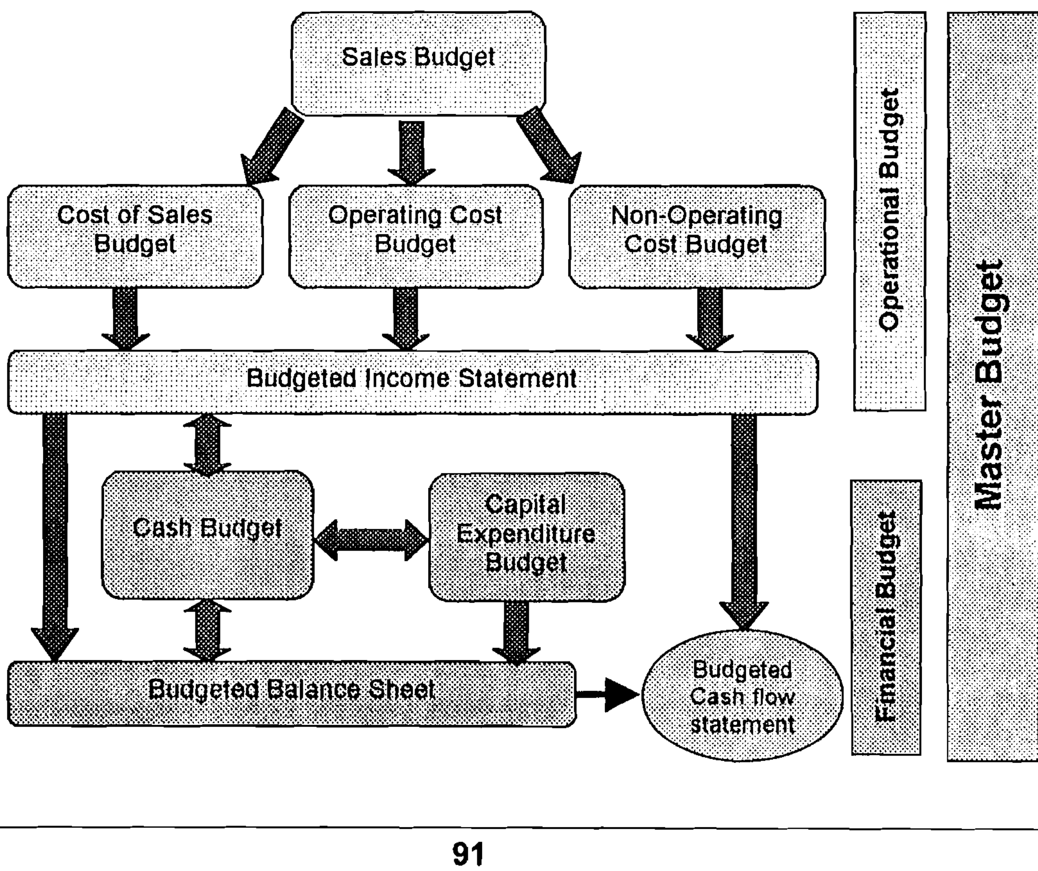
You use a Cash budget to determine the Cash receipts and disbursements implicit in the above plans. The cash budget helps you to plan the liquid resources required of your business.

You use the cash flow statement format to prepare the budgeted cash flow statement.

The budgeted balance sheet and its supporting budgets, together with the budgeted cash flow statement make up the financial budget

The budgeted income statement budgeted balance sheet and budgeted cash statement make up the master budget.

The chart below is an illustration of the relationships between the various budgets that make up the Master Budget.



a) The Operating budget

Your operating budget consists of the budgeted income statement and its supporting budgets. Before you prepare your operating budget, you need to identify the key budget factor, alternatively known as constraining factor. Constraining factors are the bottlenecks, which limit the size of growth. For many businesses, the level of sales is the budget constraining factor. For other businesses, it could be production capacity or availability of key raw materials. You also need to identify how the revenues and costs will be spread over the year. It is not sufficient to prepare just a full year's budget, as you have no milestones during the year to check progress.

To prepare the **sales budget**, you must start by preparing a sales forecast. You need to consider the following factors when preparing the sales forecast:

a)	Past sales trends	b)	General economic conditions
c)	Industrial conditions	d)	Competition
e)	Production capacity	f)	Seasonal variation
g)	Pricing policy	h)	Product profitability

CASE STUDY

Hana Juice Company (HAJCO) Ltd. Sales Budget

Sales growth is planned at 25%, however, it is necessary to understand this in terms of products, selling prices and selling strategy.

4) Cost of Sales budget

This is more complex as Mr. Jameel has to look at the component parts of this. Not just the total. His review leads him to understand:

- End inventory, the goal is to maintain 2003 inventory turns of some 16.5 times, therefore the end inventory will be JD 106.520.
- Raw materials, the volume needed will automatically increase with the increased production volume indicated in the chart above. In addition, unprocessed fruit prices are estimated to increase. The combined effect of these increases is 63.56%
- Factory wages will also increase substantially as a new production line will be opened to handle the higher volume of production. This will mean hiring an additional seven workers. In addition, wages will increase by 10% by year-end.
- Factory rent will be half the 2003 charge as the factory is purchased as of the beginning of the third quarter. There is no rent charge for quarters 3 and 4. This is replaced by building depreciation, of JD 5.000 for the second half of the year.
- Electricity and water will increase due to higher consumption, with one more production line and substantial price increases.
- Machinery depreciation will increase by JD 19.610 being depreciation of the additional equipment, but for only half the year.
- The sum of the above assumptions will bring the Cost of Sales budget to the amount in the strategic plan; any small difference will be worked during the year through more efficiency in the plant.

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Hana Juice Company (HAJCO) Ltd. Sales Budget

Continued from the previous page...

	2003	2004	2005	2006
	JD 000	JD 000	JD 000	JD 000
Beginning Inventory	46.00	35.87		
Production cost:				
Raw material	73.00	119.40		
Factory wages	22.00	66.08		
Factory rent	11.00	5.50		
Electricity and water	11.00	17.93		
Depreciation: Buildings	-	5.00		
Depreciation, Machinery	13.00	32.61		
Total production costs	130.00	246.52		
Total available	176.00	282.39		
Less: Closing inventory	33.00	106.52		
Cost of Goods sold	143.00	175.87		
Distribution costs	53.00	69.13		
Total cost of Sales	196.00	245.00		

5) Operating expense budget

Following the advice of Mr. Saber, Mr. Jameel decides to follow the functional approach for these items and restructures the costs as shown in Chapter 3, into Selling and Marketing, General and Administration, Research and Development. He then reviews his proposed plans and evaluates the development of these costs as follows:

- Sales and marketing. Mr. Jameel will work full time here during the second half of the year to develop the new distribution selling-channel. Once the new Finance manager is hired and can manage all the office work, sales will also be granted additional funds for advertising, point-of-sale advertising in supermarkets and receptions both to launch this new business and to maintain good relations with the hotels. Mr. Jameel will however release the funds progressively for these programs, depending on the evolution of the sales growth needed to fund them
- General and Administration expenses. The salary of the new Finance manager will increase costs compared to 2001;
- Research and development will continue to be 33% of Mr. Jameel's time, but office costs will be reduced compared to 2001 as part of the overall tighter control of general office expenses.
- Depreciation of office equipment will increase for the new computer equipment to be written-off over three years; other costs will be cut including transfer of Mrs. Hind to Sales and Marketing for the second half.

6) Non-operating cost budget

This comprises only Interest and Taxes, which Mr. Jameel estimates as follows:

- Interest expense. Interest expense will be reduced as a result of the reduction in the loan amount.
- Taxation. Based on information form his external accountant, Mr. Jameel continues to budget taxes at 15% of the profit before tax.

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CASE STUDY

Hana Juice Company (HAJCO) Ltd. Sales Budget

Continued from the previous page...

After taking into account

- the above trends expected during the next twelve months.
- The seasonal variations in Hana Juice Company's business and
- The breakdown of cost into their variable and fixed components

Hana Juice Company came up with the following Budgeted Income Statement

Budgeted Income Statement for the year 2004					
Item	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	TOTAL 2004
	(JD 000)	(JD 000)	(JD 000)	(JD 000)	(JD 000)
Net Sales (Turnover)	100.00	120.00	150.00	140.00	510.00
Less: Cost of Sales	48.04	57.65	72.06	67.25	245.00
Gross Profit	**51.96**	**62.35**	**77.94**	**72.75**	**265.00**
Selling and Distribution Expenses	5.4	6.2	6.3	7.1	25.00
G&A Expenses	3.2	3.4	3.6	3.8	14.00
Salaries	10.5	10.5	13.86	13.86	48.72
Bad Debts	3.00	3.00	3.40	3.21	12.61
Total Operating Expenses	**22.10**	**23.10**	**27.16**	**27.97**	**100,33**
EBITDA	**29.86**	**39.25**	**50.78**	**44.78**	**164,67**
Depreciation	6.18	6.18	7.9	7.9	28.16
Amortization	-	-	-	-	-
EBIT	**23.68**	**33.07**	**42.88**	**36.88**	**136.51**
Interest Charges	2.6	2.6	2.6	2.6	10.40
EBT	**21.08**	**30.47**	**40.28**	**34.28**	**126.11**
Corporate Tax @15%	3.19	4.60	6.07	5.14	18.92
Net Income	**17.89**	**25.87**	**34.21**	**29.14**	**107,19**

For better control, the budget should be further analysed into monthly rather than quarterly control period. Supporting budget schedules will provide detailed break down by control period, of the individual income statement line items for instance sales, cost of sales, operating expenses

Important

You don't need to work each of the components of the costs of sales in details. Just review these costs as HAJCO did in the previous case study

The above example illustrates that the annual budget is developed from:

- The strategic Finance plan, as the starting point
- Specific actions decided by the management to meet the planned growth (Sales development programmes and Production site facilities)

- Specific actions by management to build the infrastructure (New finance manager; new computer installation)
- External elements outside the company's control (Price of unprocessed fruit; general economic conditions driving Factory wages, etc).

In practice, with the exception of the use of quarterly rather than monthly control periods, the work involved in preparing the budget is close to the above case information. You can, therefore take this as a guide for preparing your own budgets (Reality may, however, be more complicated and detailed than this!).

b) The Capital Budget

In order to support the Growth plan for 2004, **HAJCO** is obliged to invest further in Machinery and Equipment for the factory. In addition, Mr. Jameel had defined in the Strategic plan that he wanted to acquire a new factory site and relocate from his farm site and to upgrade his computer installation to improve his accounting and management reporting process. All these expenditures will benefit several years into the future, but the cash required to finance them must be made available at the time of purchase. In order to plan properly the company's finances, it is therefore necessary to plan both the amounts and the approximate dates of these Capital Expenditures.

c) The Cash Budget

In addition to planning for the profitability of your business, you must also plan for the business to have enough cash to meet its obligations as they fall due.
The following table shows the differences between the calculation of profit and the calculation of case flows for a particular period.

Profit Calculation		**Cash Flow calculation**	
Revenue earned during the period. (Not necessarily collected)	XXX	**Receipts** during the period including:	
		Receipts related to revenue	XXX
Plus (where applicable **other income**)	XXX	Receipts not related to revenue, e.g. Borrowings	XXX
		Total receipts	XXX
		Less	
Less **Total Costs and expenses** Incurred during the period (not necessarily paid)	XXX	**Payments** during the period including	
		Payments related to expenses	XXX
Equals Profit for the period	XXX	Payments not related to current period expenses, for example	
		Expenditure on fixed assets	XXX
		Repayment of loans	XXX
		Payment of dividends	XXX
		Total payment	XXX
		Net cash flow (cash receipts less cash payments)	XXX

It is, therefore, possible for a business to be very profitable and yet run out of cash and be forced to close. This is particularly true of a rapidly growing business. Fast growing businesses are forced to constantly inject new funds into the business to pay for additional inventories, additional credit sales to customers and new buildings and equipment. A growing business must plan carefully or risk running out of cash.

A cash budget or cash flow projection is the most appropriate tool you can use to plan your cash flow. Through the cash budget, you can plan your business's cash receipts, payments and cash balances.

The following table shows format for the quarterly Cash Budget of HAJCO.

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Cash Budget of HAJCO

Item	2003 (JD 000)	2004 (JD 000)	2005 (JD 000)	2006 (JD 000)
RECEIPTS:				
Cash Sales				
Receipts From Accounts Receivables				
Borrowings				
Total Receipts				
Less				
PAYMENTS				
Payment to suppliers				
Salaries				
Other Operating costs (excluding depreciation)				
Interest Payments				
Corporate tax				
Purchase of fixed assets				
Repayment of loan				
Total Payments				
NET CASH FLOW (Total Receipts less Total Payments)				
Add				
BALANCE AT BEGINNING				
Equals				
BALANCE AT END				

d) Budgeted Cash Flow Statement

The budgeted cash flow statement must be clearly distinguished from the cash budget.

- The cash budget is a simple statement of budgeted receipts, payments and balances.
- By contrast, a budgeted cash flow statement is prepared in the format of the cash flow statement discussed in chapter 3. In the budgeted cash flow statement, cash flows are summarised into operating, investing and financing cash flows.

If you go to the bank and the banker asks you to submit a cash flow projection, the document that would be required would ordinarily be the cash budget rather than the budgeted cash flow statement.

Important

> Cash flow is generally a question of timing differences with the Income statement; the underlying values are the same as in the Operating and Capital budgets. Chapter 6, Management of Working Capital goes more into the details of actions to accelerate the cash flows and the advantages of this.

As with the budgeted income statement, the annual budgeted cash flow statement should be analysed into shorter control periods, for instance quarterly.

3.2.2 The Budgetary Control Phase

After you have prepared the budget for your business, you should use it to evaluate the performance of the business and its managers. The budgetary control phase involves:

- The recording of actual results
- The comparison of actual results and the budget and the identification of variances
- Drawing the attention of budget holders to the variances
- Investigation of variances and reporting the results of the investigation
- Taking remedial action on variances. Depending on the causes of the variances this may involve:
  - Controlling operations to avoid further variances
  - Revising the budget in those areas where it has been rendered unrealistic by a change in circumstance.

The following is an example of a variance report for Hana Juice Company.

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Income Statement (Variance Report) For The First Quarter 200				
Item	Notes	Budget	Actual	Variance
		(JD 000)	(JD 000)	(JD 000)
Net Sales (Turnover)				
Less: Cost of Sales				
Gross Profit				
Selling and Distribution Expenses				
G&A Expenses				
Salaries				
Bad Debts				
Total Operating Expenses				
EBITDA				
Depreciation				
Amortization				
EBIT				
Interest Charges				
EBT				
Corporate Tax @15%				
Net Income				

EXERCISE

Use the formats included earlier in this chapter for Strategic Finance three year plan in respect of

- Projected Income Statements
- Projected Balance Sheets
- Projected Cash Flow Statements

Outline the steps you need to follow to put similar processes in place for your company. Identify where you are lacking information and processes to allow you to do this, at least at a simple level. Put these into an action plan for the next 3-6 months, so you can have a first attempt at a budget for next year.

Once you have your process in place, look at your accounting system, can you get results sufficiently timely and accurately to compare results each year to allow you to react to variances, as did Mr. Jameel? If the answer is NO, then follow the same steps as for the budget to identify what is stopping you and make an action plan to remedy the problems.

Keep this activity at a very basic level. Do not be too ambitious. As soon as you have some elementary processes in place, you will quickly see how you can continually improve them into a solid management tool.

4. Chapter Summary

To ensure that your business achieves its objectives, you need to convert you strategic plan into a three-year strategic finance plan. From this, the first of the three years will be the basis for operational plan and budget. You can then use the plan to control your operations.

The principal financial planning and control tool is a budgetary planning and control system. A budget is a plan with actions, but essentially expressed in quantitative terms.

Budgetary planning and control helps you in planning, resource allocations, co-ordination of activities, communication, motivation, control and staff training and development.

You may prepare, as budgeted statements, the basic financial statements you will produce as at the end of the period. Budgets include:

- Budgeted income statement, the Operating budget
- Budgeted capital expenditures
- Cash Budget
- (With this information you could actually construct a full budgeted Balance Sheet, but this is really not necessary, as long as you have the key metrics identified such as Inventory levels (inventory turns); Accounts receivable collection period (DSO) and of course, cash.)

The whole set of budgets is referred to as the master budget.

You should use the Cash Budget to track and manage the actual cash flows of your business. No matter how profitable your business may be, it must not run out of cash. By closely monitoring your cash flows by means of the cash flow budget, you can ensure that your business has the healthy cash flows needed to fund the investments for growth.

5. Make an action plan for financial planning and control

Complete the form below in respect of your financial planning and control. The following action plan is useful when you prepare your financial growth plan where you can have a master action plan for all aspects of your financial management.

You can find the forms for preparing your Action Plan in the Financial Management Growth Plan.

ACTION PLAN

OBJECTIVE (What to achieve?)	ACTIVITIES (What should be done?)	TIME FRAME (When it should be done?)		RESPONSIBILITY (Who should do it?)	RESOURCES (How should it be done?)	COMPLETED
		START	END			
						❑
						❑
						❑
						❑
						❑
						❑

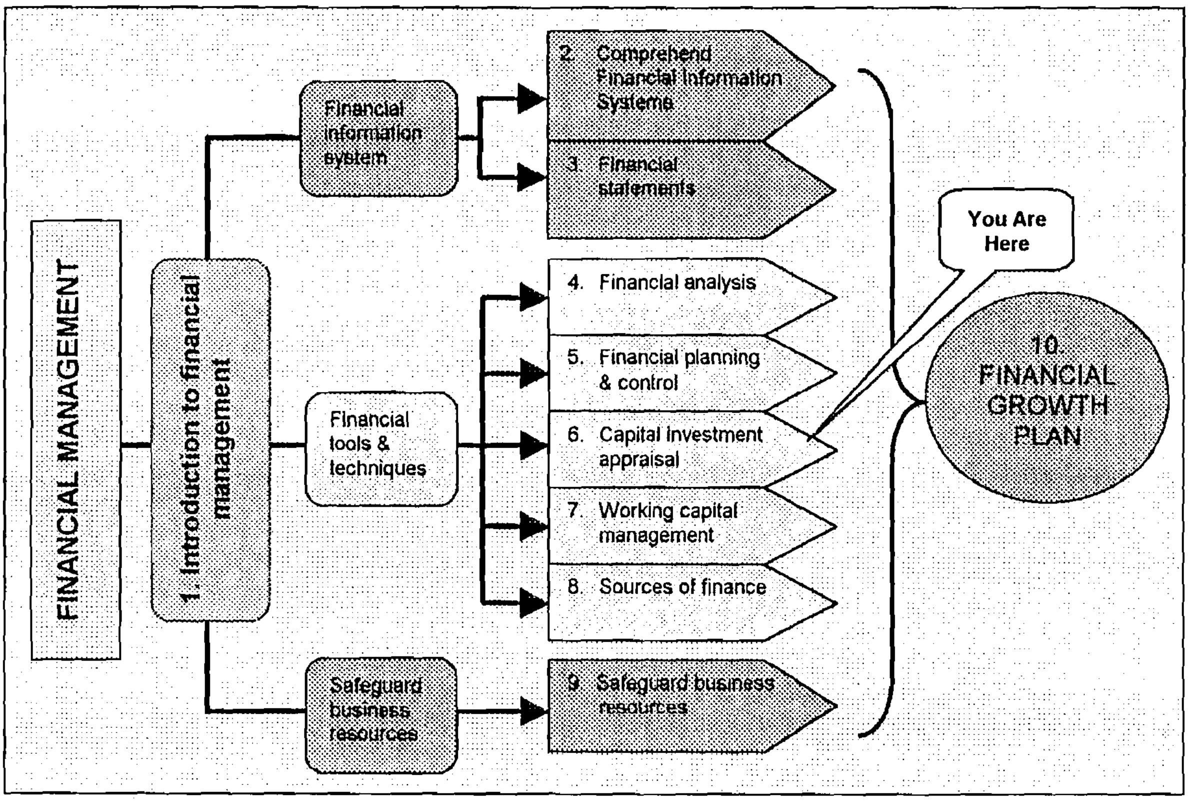
Chapter
6

EVALUATE YOUR CAPITAL INVESTMENTS

What you will learn in this chapter ...

After studying this chapter, and completing the exercises in it, and with the guidance of your business trainer, you should be able to:

- Define capital investment appraisal.
- Explain the importance of capital investment appraisal to your business.
- Use investment appraisal tools and techniques to evaluate your future investments.
- Calculate and interpret investment appraisal indicators.



1. What is capital investment appraisal?

As your business grows, you will need to invest, for example, in a new delivery truck to increase your distribution capability; new machinery to increase your production capacity or you may want to start a new business line, which will require investment. The profitability returns from these types of investments must equal or exceed the return on investment you plan to make for your shareholders, the Return on Equity ratio described in Chapter 4 to make them worthwhile for the company. The process of identifying, analysing and selecting such investments is, as **capital investment appraisal**.

By the end of this chapter, you will have a more advanced understanding of the more common investment appraisal tools that can help you to make sound investment decisions for the implementation of your growth plan.

2. Why capital investment appraisal is important?

Your investment decisions are very crucial, as they represent a cost commitment, which is often substantially higher than other expenditure decisions. Additionally, the benefits will not be immediate, but over a period of several years in the future. It is therefore, necessary to be sure that the profitability over the entire life of the investment project meets the profitability goals.

When you have sufficient funds to invest in a number of projects, you will need to select projects not only according to the availability of funds, but also according to their profitability. You may find it helpful to rank projects in order of profitability. This ranking will help you choose the best investment for your company.

Capital investments tie-up your precious capital, and may lead your business to cash shortages for the day-to-day business activities making it necessary to borrow cash to finance them. Those borrowed funds are re-paid with interest. In that regard, you must consider the cost of capital, and ensure that the rate of return you get in from your investment is enough to compensate you, and to pay the costs of borrowing from the bank.

3. Investment appraisal tools and techniques

There are number of techniques to analyse the feasibility and attractiveness of investments you are considering. Furthermore, these techniques are used to choose the best option from alternative investment opportunities. The tools that are considered in this module are:

- Pay-Back Period **(PBP)**
- Net Present Value **(NPV)**
- Profitability Index **(PI)**
- Internal Rate of Return **(IRR)**

NPV and **PI** are interchangeable and very similar in concept, but we will explain both as either may come-up in your practical experience, for example, a requirement of a bank or other financing institution.

3.1 Payback period (PBP)

The payback period of an investment tells us the number of years required to recover your initial investment based on expected cash flows from that investment.

The formula for the payback period calculation is simple; the annual cash flows are distributed evenly over payback period. Initially, net cash inflow is determined. Then, it is then divided by the initial investment.

$$\text{Payback Period} = \frac{\text{Original Investment}}{\text{Annual Cash Flow}}$$

When the cash flows are uneven, the payback period calculation is somewhat more complicated. In this case, the annual cash inflow is accumulated until the original investment is recovered. The payback period in years equals the amount of time necessary to recover the initial investment.

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Example

Mr. Jameel was interested in buying a new machine. His supplier offered him two options with the following cash flows.

Year	Option- I (J.D)		Option –II (J.D)	
Cost	(8,000)		(7,000)	
	Annual	Accumulated	Annual	Accumulated
Cash flow year 1	4,000	4,000	2,000	2,000
2	3,000	7,000	2,000	4,000
3	2,000	8,000	3,000	7,000
4	1,000		3,000	
Payback period	**2.5 years**		**3.0 years**	

Option – I, selected because the cash flows generated by the machine for **HAJCO** industries will create a shorter payback period than the cash flows the second investment: (2.5 years vs. 3.0 years).

Important

Payback Period analysis, whilst providing valuable information from a cash management perspective, does not give any indication as to the real profitability of the investment. It ignores the value of any income arising once the original investment has been recovered.

Companies use **Payback** mostly as a restrictive criteria in that, they will chose not to take projects with payback beyond say three years, as this ties-up capital for a too long period, and the longer the time to recover the original investment, the greater the risk of problems.

One problem you may encounter with Payback is that it uses the basic accounting assumption of the constant value of money, which is very misleading in an inflationary environment. This can render the use of payback very misleading. One way to overcome this is to make assumptions about the future local inflation rate, and therefore, the weakening exchange rate of the local currency. You can then convert all the future revenue predictions into a strong currency (JD) using these assumed future weakening rates.

3.2 Net Present Value (NPV) - The time value of money

Important

In making investment decisions, it is very important to consider the concept of "The time value of money" because your investment today will generate incoming cash, as a series of cash flows going out into the future.

It is a fact that money received at a future date is not of the same value as money received today, in that, you do not have the opportunity to invest that money until you actually receive it!

Let us assume that your bank will pay an annual interest rate of 10% on deposits. Thus, if you deposit JD 100 on January 1, the interest for the year to December 31 will be JD 10 and the balance on your account at December 31 will be JD 110. You can therefore conclude that JD 110 available one year from now has a value today of JD 100 (Assuming the interest rate of 10% per annum). From this assumption, you can develop the following tables:

Year	Beginning Investment	Interest 10%	Ending Investment*
One	J.D. 1.00 reinvested	J.D. 0.10	J.D. 1.10 this is then for a second year
Two	J.D. 1.10 reinvested	J.D. 0.11	J.D. 1.21 this is for a third year
Three	J.D. 1.21 reinvested	J.D. 0.121	J.D. 1.331 this is for a fourth year
Four	J.D. 1.331	J.D. 0.1331	J.D. 1.4641
Etc., etc. ...			

If we then take this logic, and ask the question "How much do I need to invest today to have exactly JD 100 in my account at the end of a given number of years?" you can create the following table:

Number of years ahead	End Capital	Division Factor*	Original Investment
One	J.D. 100	1.1	J.D. 90.90 (100/1.1)
Two	J.D. 100	1.21	J.D. 82,64 (100/1.21)
Three	J.D. 100	1.331	J.D. 75.13 (100/1.331)
Four	J.D. 100	1.4641	J.D, 68.30 (100/1.4641)

That is to say that if you invest J.D. 68.30 today at an interest rate of 10%, in four years you will have exactly J.D. 100 in your account. To prove this:

Year 1	Start	J.D. 68.30	Interest 10%	J.D. 6.83	End	J.D. 75.13
Year 2		J.D. 75.13		J.D. 7.51		J.D. 82.64
Year 3		J.D. 82,64		J.D. 8.26		J.D. 90.90
Year 4		J.D. 90.90		J.D. 9.09		J.D. 99.99+J.D. 0.01 rounding=J.D. 100

Thus, we can conclude that receiving J.D. 100 four years from now is the same as receiving J.D. 68.30 today. That is to say, that today's value, or the **Net Present Value,** of J.D. 100 received four years from now is J.D. 68.30. Similarly, the **Net Present Value** of J.D. 100 received in three years is J.D. 75.13; in two years, **NPV** is J.D. 82.64 and in one year, **NPV** is J.D. 90.90.

With this logic, you can recreate the same table at any given interest rate to know the NPV of money received at any time in the future.

You can conclude therefore, that it is very important for you to determine future revenues (or costs) at their Net Present Value to evaluate your investment decisions. In this way, you can determine whether an investment gives the required return, taking into account the time-value of money. That is to say, are you getting equal or better than the rate of Return on Equity you want to earn for your shareholders? With this knowledge, you can easily conclude whether a given investment can earn a satisfactory return or not.

Furthermore, suppose you want to select the most profitable investment option from a set of investment opportunities. By determining the NPV of each opportunity, you will quickly see which is the most attractive, and which opportunities meet the minimum requirement for shareholders Return on Equity.

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Example

HAJCO plans business growth. To do this, they need to build a factory on a new site, but Mr. Jameel wants to be sure that the cost of the new plant will yield the same or better returns than he has determined in his Strategic plan for Return (Return on Equity – RoE). He asked Mr. Saber to calculate to see if the offer he has received gives a return of at least 15%, as defined in the Strategic plan. The plant re-location will cost J.D. 200,000, fully equipped and should be usable for at least six years. The estimated additional revenues and operating costs are:

Year	Income (J.D.)	Costs	Net Income
1	85,000	42,500	42,500
2	95,000	47,500	47,500
3	100,000	50,000	50,000
4	120,000	60,000	60,000
5	145,000	72,500	72,500
6	120,000	60,000	60,000

Mr. Saber wants to want the Net Present Value of the project using the required return on Investment rate of 15% to decide whether the business is worthwhile. He therefore, built the following table of NPV values:

Year of Cash Flow	Gross Cash Flow	Discount factor*	NPV of Cash flow
Zero (Investment)	(J.D. 200,000)	1.00	(J.D. 200,000)
One	42,500	1/1.15= 0.870	36,975
Two	47,500	0.87/1.15= 0.757	35,958
Three	50,000	0.757/1.15=0.658	32,900
Four	60,000	0.658/1.15=0.572	34,320
Five	72,500	0.572/1.15=0.497	36,032
Six	60,000	0.497/1.15=0.432	25,920
Total NPV of project	**2,105**		

As this **NPV** is positive, this shows that the desired rate of return is in excess of the required 15%. The sum of future net revenues expressed at their current values, (J.D. 202,105) exceed the investment cost of J.D. 200,000. **THIS PROJECT TO BE ACCEPTED.**

EXERCISE

Choose a new investment you are contemplating, and complete the following chart for the number of years the investment will be useable. If you are uncertain, do not exceed five or six years as the future beyond this timeframe is too uncertain, and the investment should justify itself within that timeframe.

Year	**Income (J.D.)**	**Costs**	**Net Income**
Zero (Investment)	None	Cost of investment	Cost of investment
One- Operating activity	Additional sales	Additional operating costs	Net income (loss)
Two-Operating activity	Additional sales	Additional operating costs	Net income (loss)
Last year of project	Disposal value, if any		Disposal value

- Enter the above information into the chart as described previously
- Chose your required Return on Investment rate (per your strategic plan)
- Complete the chart, as in the example, if value is positive, the required rate is reached the project acceptable. If the value is negative, accepting it will dilute future profits
- Track the actual performance each year to ensure forecast net revenue is achieved.

3.3 Profitability Index (PI)

Practically, the profitability index is another presentation of the net present value. In NPV calculations, you deduct the net cash outflows from the net cash inflows to end up with and absolute value that does not reflect the size of the project. However, in profitability index calculations, you divide the cash inflows over the cash outflows to measure how many times the present value of project's returns cover the present value of the project's costs.

The profitability index is very useful when comparing projects to select the best option since it considers the effects of the project size on the comparison, which the NPV does not consider.

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Example

Mr. Jameel received another offer for the factory extension, which will cost him J.D. 100,000 with a net present value (NPV) of J.D. 1,900.

In the previous example, the NPV was calculated at J.D. 2,105, but if you consider the NPV exclusively, the conclusion would be that the first offer is better, because it has higher NPV! This is a misleading conclusion, since it ignores the scale of the project's cost.

In profitability index calculations, the PI is calculated as follows:

Option 1: PI= 202,105/200,000=1.01 times

Option 2: PI= 101,900/100,000=1.02 times.

From a profitability (index calculation) perspective, Option 2 is better, since it has higher PI.

3.4 Internal Rate of Return (IRR)

The internal rate of return is the discount rate that makes the net present value equal to zero. If the IRR is higher than the investor cost of capital, the project is feasible since its returns are higher than required rate of return by investors

Calculating the IRR via one of three methods:

- **Using the computer:** Any financial software or Microsoft Excel.
- **By trial and error**: To keep trying different discount rates to get a zero NPV.
- **By graphical display**: There is a linear relationship between **IRR** and **NPV**, therefore, drawing a line between a discount rate that gives a positive **NPV**, and a discount rate that results in a negative **NPV** will cross the axes where **NPV** is zero.

We introduce this concept to help you understand the meaning and implications of IRR, not for calculating the IRR.

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Example

The IRR of expansion Option 1 of the previous example is calculated by using Microsoft Excel worksheet to be 15.3%, which indicate that the expansion project is feasible and profitable, since the IRR is higher than the required rate of return (15%).

4. Practical application

The real work in using this kind of tool is however, in making good estimates of the cost of the investment, and the potential revenues and operating costs relating to the specific investment project. Here, there is no alternative to making a very detailed and realistic study of these elements, based on all available information. The risk is to be too optimistic in order to justify the investment, as emotionally you will naturally want the result to show the project to be attractive. It is therefore advisable for each investment that you determine the performance really achieved, year by year, in order to build your experience in making these forecast evaluations.

5. Chapter Summary

Capital investment decisions are very crucial, as they represent a cost that is often, substantially higher than other expenditure decisions. Additionally, the benefits will come over a period of years into the future. Therefore, it is important to evaluate the feasibility of those investments before you commit to them. Capital investments (appraisal techniques) provide the tools for such evaluation.

The payback method tells you the number of years required to recover your initial investment based on expected cash flows from that investment. It enables you to compare and choose the project with shortest payback period from different alternatives. You should, also set a payback limit for all projects to achieve, this should not be more than four or five years as the future is too uncertain beyond that.

In making investment decisions, it is very important to consider time value of money, because the return for your investment today will be received as a series of cash flows well into the future. The present value. of those cash flows may not always be enough to compensate you for your investment. Therefore, it is very important to calculate the value of future revenues (or costs) to their present value to evaluate your investment decisions.

6. Make an action plan for using capital investment appraisal tools

Complete the form below to use capital investment (appraisal tools). The action plan shown in the next page is useful when you prepare your financial growth plan, where you can have a master action plan for all aspects of your financial management.

You can find the forms for preparing your Action Plan in the Financial Management Growth Plan.

ACTION PLAN

OBJECTIVE (What to achieve?)	ACTIVITIES (What should be done?)	TIME FRAME (When it should be done?)		RESPONSIBILITY (Who should do it?)	RESOURCES (How it should be done?)	COMPLETED
		START	END			
						❑
						❑
						❑
						❑
						❑
						❑

ACTION PLAN

OBJECTIVE (What to achieve?)	ACTIVITIES (What should be done?)	TIME FRAME (When it should be done?)		RESPONSIBILITY (Who should do it?)	RESOURCES (How it should be done?)	COMPLETED
		START	END			
						❑
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						❑
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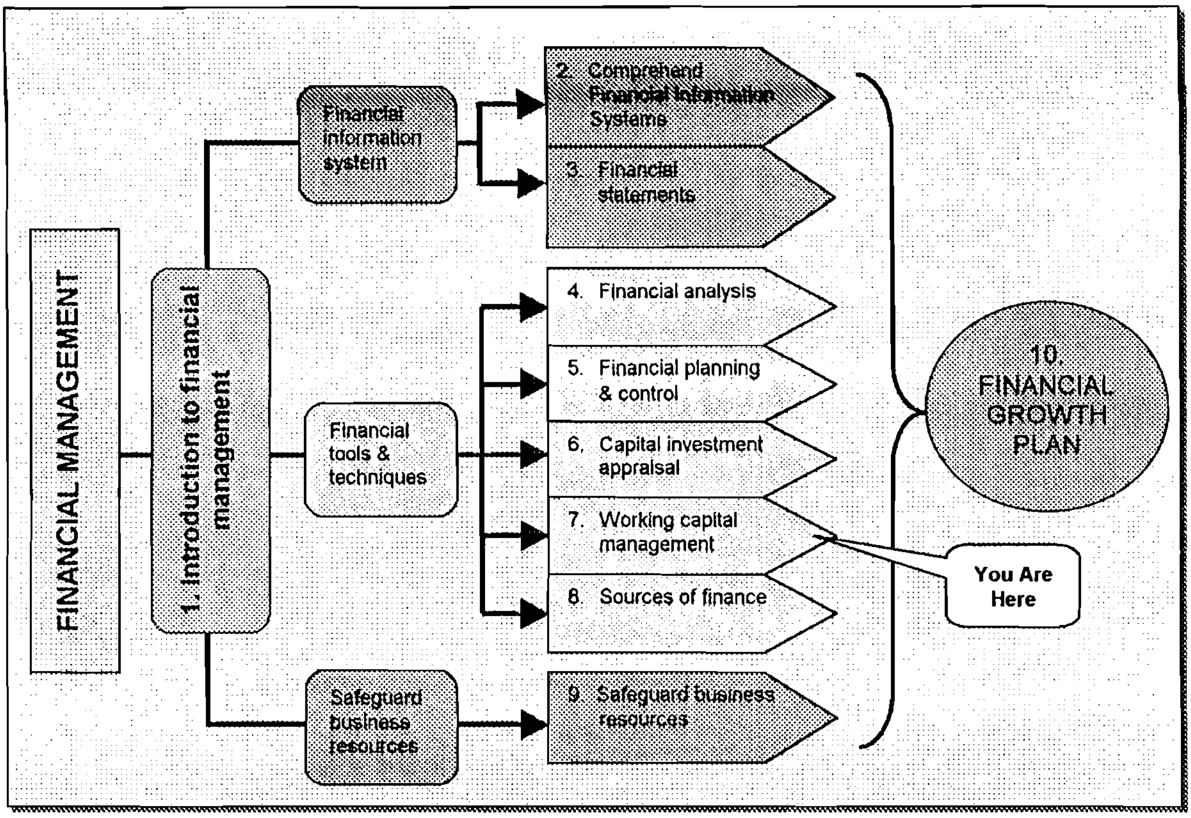
Chapter 7

MANAGE YOUR WORKING CAPITAL

What you will learn in this chapter ...

After studying this chapter, and completing the exercises in it, and with the guidance of your business trainer, you should be able to:

- **Assess your working capital requirements.**
- **Explain the importance of working capital to your business.**
- **Manage your working capital for business growth.**
- **Explain the working capital cycle.**
- **Manage your accounts receivable.**
- **Establish your credit policy.**



1. What is working capital management?

Every enterprise has to arrange for adequate funds to meet day-to-day expenses, apart from investing in fixed assets. ***Working capital*** is the capital that is needed and available for you to conduct the day-to-day operations of your business. Thus:

> ***Net working capital*** refers to the net of current assets (including inventory, accounts receivable and cash), and current liabilities (including accounts payable, accruals and bank overdrafts).

Net Working Capital = Current Assets – Current Liabilities

All terms used in Net Working Capital definition are described in detail in Chapter 3.

Alternatively, net working capital is termed as **working capital.**

Imp

Working capital management refers to the administration of the firm's current assets and short-term financing needed to support the activities in the normal business operating cycle.

As your business grows, the need for working capital will increase, but so will your scope for being more efficient. The challenge is to keep the Working Capital investment, as small as possible, to free-up funds for real growth investments. This chapter focuses on managing the levels needed, and the efficient management of your current assets. The financing of current assets is explained in Chapter eight, which deals with the whole topic of sources of finance

To illustrate Working Capital, here is the **HAJCO** example for 2001-2003, as shown in Chapter 3, **BUT** with additional projections for **2004.** To illustrate what will happen if tight control is not maintained over the level of Current Asset items, such as Accounts Receivable (Collection process continues to perform badly) and Inventories (build-up due to lack of co ordination of production with sales):

Assets	2001	2002	2003	2004 Projection
Current Assets:	In thousands of JD			
Cash on hand and at banks	54.80	36.77	62.95	100.92
Inventories	160.00	170.00	180.00	190.00
Accounts Receivable	20.00	27.00	34.00	41.00
Total Current Assets	**234.80**	**233.77**	**276.95**	**331.92**
Current Liabilities:				
Accounts Payable	129.16	122.70	116.57	110.74
Accrued Expenses	30.00	25.00	20.00	15.00
Total Current Liabilities	**159.16**	**147.70**	**136.57**	**125.74**
Working capital	**75.64**	**86.07**	**140.38**	**206.18**

The increase in ASSETS is a good thing if you can finance it with cash. A dramatic increase in Net Current Assets or **Working Capital** of J.D. 65,800 (J.D. 206,180- J.D. 140,380) as projected here is lower than the profits generated, so there is no need for outside financing by loans. However, using the cash resources and borrowing capability to finance non-productive current assets may prevent using these resources for the investments essential for the planned growth of the company.

On the other hand, running out of working capital is worse! For example, the Inventories and Accounts receivable could be managed down to a very low level, which is good, but without an equivalent increase in Cash (presumably due to over-investing, paying excessive dividends to shareholders or business being less profitable, or a combination of these elements). The consequence here is that there are not enough liquid assets to pay the creditors! In either case, a very bad piece of asset management, avoid this at all costs!

2. How working capital management can help you expand your business.

The management of working capital is important to ensure that there are sufficient funds available at all times to cover ongoing cash outlays:

- To meet the acquisition and storage cost of inventories of raw materials, work-in-process, finished goods and consumables,
- To pay for wages and salaries
- To meet production, operating and other overhead costs, including administration, selling and distribution costs.

With the growth of your business, you may find that you need more and more working capital to meet the above purposes. As a guideline, the current assets of a merchandising (wholesaling and retailing) business, generally account for over half of its total assets. For a manufacturing business, they may account for even more as the completely manufacturing cycle needs financing.

Be aware however, that excessive working capital leads to a lower rate of return on your business' total investment. For instance, unnecessarily high inventories do not add to your business' efficiency or profitability, but increase inventory management costs and losses due to theft, wastage, mishandling and obsolescence.

On the other hand, inadequate working capital results in shortages and difficulties in maintaining smooth operations. If your investment in working capital is inadequate, you will fail to meet your obligations to both customers and suppliers. This will result in loss of goodwill and creditworthiness. Current liabilities are the source of external financing of current assets. This is attractive, because the money is free of charge, but do take care to pay your suppliers correctly, as defaults can lead to cutting-off supplies, a bad reputation in your industry and inability to negotiate good prices in future.

Small businesses can often experience cash shortages during their growth and expansion phase.

These shortages can retard the growth of your business. Some common causes of these shortages are:

- **Excessive inventory holding**: excessive stock ties-up precious cash. You hold the stock in storage, and you only convert to cash when you sell it. While sitting in storage, it can loose value through wastage or obsolescence.
- **Increase in investment in Accounts receivable (debtors)**: extension of credit to customers deprives you of cash. You produce the goods or services, and incur costs of production, but your customers do not pay you immediately on delivery.
- **Acquisition of fixed assets for cash**: the acquisition of additional equipment for cash will lead to increases in activity and therefore, cash in the long, but reduces working capital in the short term.

- **Increase in sales and marketing costs**: to increase your sales, you will certainly need more resources to penetrate new markets and develop customer contacts. There is a time lag between these activities and the additional inflow of cash from the new business. This again increases cash outflows in the short-term.

Careful working capital management will help you to plan and manage your current assets to ensure smooth operations and growth of your business. Your goal must be to convert all current assets, particularly inventories and accounts receivable, to cash, as quickly as possible, in order to use this cash to finance the investments needed for your continued growth.

3. How to manage your business' working capital

In order to manage your business' working capital efficiently, you need to:

a) Have a clear understanding of the objectives of sound working capital management,

b) Have a sound appreciation of the factors that determine your working capital requirements,

c) Apply appropriate working capital management tools and techniques

3.1 Objectives of sound working capital management

Working capital management involves the management of all aspects of both current assets and current liabilities with the following intention:

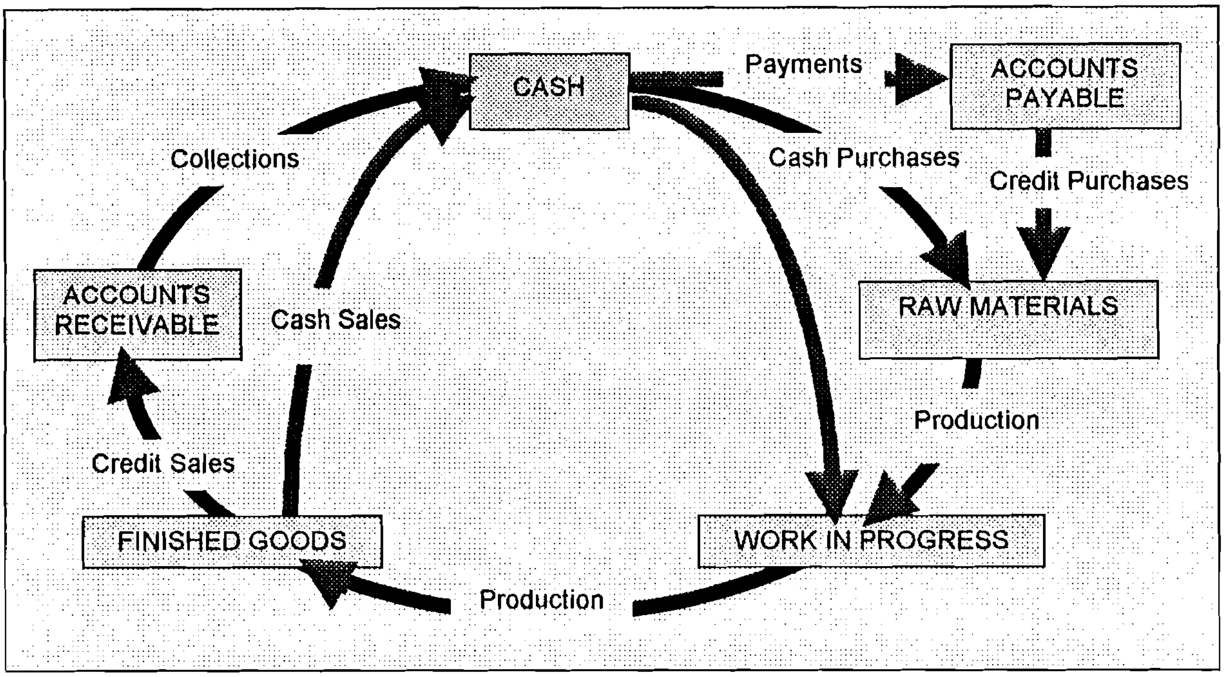
- On one hand, minimising the risk that the business may fail to meet its obligations as they fall due, and
- On the other hand, maximising the returns on its assets by not carrying excess working capital.

It is, therefore, necessary to determine the minimum level necessary for each item of current assets, and to negotiate the most favourable payment terms for all purchases of goods and services.

3.2 Determinants of working capital requirements

The chart shown on the next page, illustrates the working capital cycle, and the points where your working capital is tied-up in the process of the business operation.

Working Capital Cycle



The amount of working capital required for the smooth operation of your business depends on several factors:

- **Cost of raw materials**: working capital will be larger if the cost of raw materials is high.
- **Quantity and value of inventory:** if you need to keep large inventories of raw materials and finished goods, your working capital requirement will be high.
- **Duration of production period:** if it takes a long time to complete the production cycle, you will tie up more funds in work-in-progress than if your process time is shorter.
- **Credit sales and cash purchases:** if you do more sales on credit, and if you purchase on cash, you will need much more working capital.
- **Type of business:** generally speaking, manufacturing businesses need more working capital than merchandising businesses, as their business cycle is longer due to the time required for production.
- **Growth and expansion**: fast growing businesses require larger amounts of working capital than businesses that are not growing, as the level of activity drives the Working capital requirement.
- **Inventory turn over ratio**: if your stocks are turning over fast, you will need fewer inventories in relation to the activity than if they turn slowly.

3.3 Working capital management tools and techniques

Working capital management tools and techniques help you to:

a) Decide on optimum working capital management policies, and

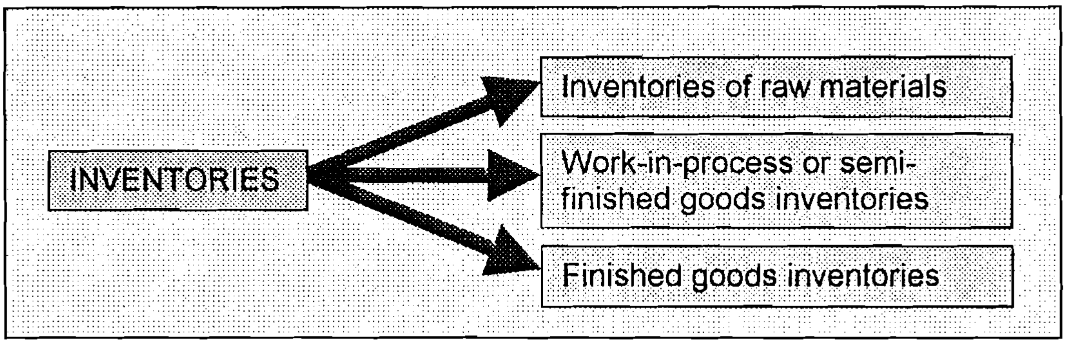
b) Monitor the operation of those policies.

The working capital management policies you select will determine your level of investment in inventories, accounts receivable or other items of working capital. In this manual, specific tools and techniques are dealt with under each class of working capital item.

■ Inventory management

Inventories consist of three major types of business stocks. The following shows the three main types of inventories:

Three Main Types of Inventory



In some businesses, inventories of consumables may also be significant.

The objective of sound inventory management is to maintain an optimum level of inventory. To achieve this objective, you need to strike the right balance between

- **Holding too much inventory:** to ensure the efficient and profitable use of the capital invested in inventory, you should not hold too much inventory, whilst at the same time,
- **Holding too little inventory:** to ensure the smooth operation of your business, you need enough inventory to avoid disruptions to production and deliveries resulting from running out of inventory.

The table shows in the next page, problems caused by having too much or too little inventory in your business

Excess inventory	Insufficient inventory
• Unnecessary locking up of funds • High inventory carrying cost • Risk of theft, deterioration and obsolescence	• Frequent stoppages of production • Failure to supply finish goods in time • Excessive order cost and transportation cost associated with emergency buying and shipping.

There are numerous mathematical formulae to calculate required inventory levels, and to evaluate the efficiency of a business' inventory management. The following table summarises two of these formulae. It is important for you to use this type of approach in Inventory goal setting and to measure your actual performance. In this way, you will keep your investment in inventory well under control.

Required inventory holding (Give a target inventory turnover period)	**Inventory turnover period** (To evaluate whether the business is operating in accordance with its policy with respect to its target inventory turnover period)
Average Inventory Holding = Target inventory turnover period $\times \frac{\text{Cost of sales}}{365}$	Inventory Turnover Period = $\frac{\text{Average inventory}}{\text{Cost of Sales}} \times \frac{365}{1}$

It is advisable to break-down inventory into:

- **Raw materials**
- **Work in progress**
- **Finished goods**

In addition, establish the inventory turn goals and targeted inventory level for each category. The formula and process will be the same as that shown above for each category, but this allows a finer level of Inventory management.

The following Case Study illustrates the application of these formulae, as used in Chapters 3 and 4 for setting the budgeted inventory level for 2002.

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

You will recall from Chapter 4, how we identified the benefits of tighter inventory control for **HAJCO.** By having a better understanding of the amount of unprocessed fruit needed for production, and how much finished fruit juice is needed for delivery to the hotels, Mr. Jameel was able to avoid carrying more inventory than he needed. This resulted in the following performance of minimising inventory investment:

Inventory turns by year	2001	0.69	Times
	2002	0.89	Times
	2003	1.09	Times

The improvement in 2003 came about because of focus in this area and particularly significant improvements in the manufacturing processes designed by Mr. Jameel concluded that any further improvements to the processes would have only marginal impact and, therefore, decided to focus his R&D efforts on developing the new products he wanted to introduce.

Given this goal, and an annual cost of goods sold of (in thousands of JD) J.D. 1,633, what will be the ending inventory target? The formula is:

$\dfrac{\text{Annual Cost of Sales}}{\text{365 days}}$ = Average Cost of Sales / Day Times planned inventory turns

= Planned year-end inventory

■ Accounts Receivable (Debtors) Management

The pressure to extend credit to customers often comes from the need to increase sales. When credit is, available customers buy more. On the surface, this seems like a very good thing, and is the growing practice for business between to businesses. However, you should be very careful about how you manage the extension of credit to customers. When making a decision to extend credit to your customers, always weigh the costs of extending credit against the benefit related to increased sales.

Advantages and Disadvantages of Granting Credit

Advantages	Disadvantages
Extending credit to customers enables your business to: - • Stay competitive in your industry and market place • Expand into new markets or to increase your share of an existing market • Increase sales and profits	• Extending credit to customers places a heavy burden on the firm's working capital • Granting credit to customers raises the risk of not being paid • Credit collections can also be expensive and time consuming

As your business grows, you will have to extend more and more credit to your customers. Before you decide to extend credit to your customers, you must first establish a credit management system in your business.
It involves the following steps:

Determining credit policy	Which includes: • Setting the credit standard • Evaluation of potential, and selection of credit customers • Deciding on specific credit terms for each customer
Collection policy	Which includes: • Ensuring compliance with credit terms • Ensuring timely invoicing to customers • Control and analysis of accounts receivable (debtors) • Defining procedure to follow up on defaulting debtors.

■ Credit policy

Credit policy involves the determination of credit standard, credit selection and credit terms.

Credit standard: credit standard refers the minimum requirement for extending credit to a potential customer. The key variables that should considered in the setting or changing of a credit standard include the effect of the proposed standard on sales volumes, the level of investment in debtors, and the risk of losses through bad debts. Some credit standard systems rely on a credit rating system. The following example, illustrates the application of a credit standard based on a rating system by **HAJCO** to its hotel customers, using a theoretical customer as an example.

The following table defines procedures for credit limit setting and collecting customer payments

Credit Standard Assessment Form

Customer: Name of Customer Credit characteristic	Score Scale of (0-100)	Average Score (Total divided by 600)
a) Type of entity: Limited liability company	100	
b) Profit range: J.D. 500k-J.D. 750k p.a.	80	
c) Years business exists: 20 years	90	
d) Building owned or rented: Owned	100	
e) Credit references from bank or other: Bank	80	
f) Payment history (Credit agency) rating: Good	90	
Total and average (Required average is 60%)	540	90%

Notes:

a) It is much better to deal with a registered company where you can consult the state company's register to obtain information about the company, its officers and its annual audited financial statements. A sole trader is much more risky.

b) You would naturally want the client to be consistently profitable.

c) The longer the client has been in business, the better. Anything beyond 10 years is good.

d) Ownership of property is a positive indicator.

e) If you can, get the customer to give you a bank reference. Third-party references are however, less indicative than direct information.

f) If you can, get a report from the credit agency this can also, add some degree of assurance, if positive.

g) The above is an example, you may of course define your own criteria and minimum score required, but you must be consistent across all customers. Even if the method is subjective, it allows you to rate customers and possibly highlight risks.

Evaluation of credit applications involves following steps:

a) Collection of credit information about the customer

b) Investigating the credit capacity of the customer

c) Credit analysis

d) Fixing credit limits

e) Deciding collection procedure

The credit information about individual customers is collated from financial statements, trade references, bank references and credit bureau reports.

In evaluating the creditworthiness of your credit applicants, you need to assess them via the **5Cs of credit:**

Important

The 5Cs of credit applicants

- Character; willingness of the customer to pay (Supported by references)
- Capacity; the ability to pay (Supported by projected incomes and cash flows)
- Condition; prevailing economic conditions and conditions of potential customers (Supported by analysis)
- Capital; availability of funds/Customer's net worth (Supported by balance sheet where applicable)
- Collateral; value and nature of security (Supported by value of security)

Credit selection: credit selection is concerned with deciding whether, or not to extend credit to a potential customer and if so, how much credit to extend. To qualify for credit, a customer needs to meet the minimum criteria set by the credit standard. A business cannot follow the policy of treating all customers the same way in matters of extending credit. It should have clear guidelines and procedures for granting credit to individual customers.

Credit terms: are the terms under which a business's credit customers are required to pay their accounts.

Credit terms may cover such issues as:

i. The **cash discount** offered to customers to reward early settlement. Be careful though, this is pure profit given away, and should be only 1 or 2 percent if you can afford it, and if you really need the faster cash collection for your own cash flow needs.

ii. The **cash discount period:** is the period within which a customer should settle an account to qualify for a cash discount, should not be more than 10 days for cash or money already in your bank account, and be prepared to make the effort to control this!

iii. The **credit period**: is the time within which a customer is required to settle an account before collection procedures come into affect. Normally, this is 30 days. If a customer requires extended credit beyond this, an additional premium placed on the invoice to cover the cost (time value of money – see Chapter 6) for customers who do not pay within the prescribed period.

iv. The **Credit limit:** the maximum permitted unpaid balance a customer to accumulate on his account. Deliveries will be suspended if this limit is exceeded until payments are received to bring the balance back within the limit.

■ Determining collection policies and methods

The collection policy is the set of procedures for collecting amounts due from customers. It is important to develop a collection policy before you begin granting credit to your customers. Many companies wait until they have problems collecting from their customers before they institute a collection policy. By the time, a customer reaches the point of having trouble paying you, the problem may be very difficult to resolve. It would be far better if you start working with the customer before the first sign of trouble.

Important aspects to consider in a collection policy include:

- Ensuring compliance with credit policy
- Ensuring timely invoicing to customers
- Control and analysis of debtors
- Defining procedure to be followed on defaulting debtors.

The need for, and procedures for, ensuring compliance with credit policy and timely invoicing of customers are obvious.

■ Control and analysis of receivables

In order to control your accounts receivable, you need to analyse them using:

a) Relevant ratios (see Chapter 4) to get a broad picture of the status of the debtors

b) An aged analysis of individual and total amounts past due.

This will help to keep the investment in accounts receivable within reasonable limits, and to manage better the liquidity of the business assets.

a) **Accounts receivable ratios**: chapter Four describes the collection period (**DSO** – Days Sales Outstanding) ratio and Chapter Five shows how this in use

b) **Age analysis of debtors**: you need to monitor your debtors to ensure that they do not become long overdue or, if they do, you are able to take appropriate action. Remember that the longer the debt is overdue, the higher the risk that it may be irrecoverable.

Let us now look at HAJCO, their credit policy and recent performance:

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Credit Policy – Credit Selection
Customer Credit Problems (Extract from Strategic Management Manual, Case introduction)

Mr. Jameel noticed that, as his business grew, more and more of his customers demanded credit. Some of these customers were very loyal to him, and ordered large quantities of product. He felt that he could trust these customers and they would pay him on time.

Mr. Jameel met with his sales staff and discussed the issue of customer credit with them. They all felt it was very important for him to extend credit to all of the customers. They said it seemed unfair to give credit to only a few customers, whilst others are deprived. The customers that did not get credit would complain when they found out that they were being treated differently.

After meeting with the sales staff and hearing their opinions, Mr. Jameel decided that he would extend the same amount of credit to all of his customers. He set the credit policy that customers could pay for their orders 30 days after they received the order. He decided that all customers would be allowed credit because that seemed fair. He did not want anyone to feel treatment was unfair.

After a few months, Mr. Jameel noticed that his company was running out of money. Cash was always a problem, but now it was constant. This fact was even more surprising considering that sales were improving, since they had started extending credit to customers.

Mr Jameel realises that he has an urgent problem and asks his old friend and colleague, Mr. Saber, to help him sort out how to manage his customers. Together, they draft the following Credit and Collection Policy document.

Credit Policy – Credit Selection
Credit and Collection Policy of HAJCO

1. Credit considered for customers who are in good standing and have an existing relationship with us.
2. Customers who wish to receive credit must submit a credit application.
3. On receipt of the credit application, references are taken up.
4. For existing and established businesses, credit facility established within 30 days after submission of application.
5. For new businesses, we require that they develop a relationship with us, and place a minimum of at least 6 orders on a C.O.D. basis.
6. After the granting of credit, statements despatched on a monthly basis. All monthly balances are due on a net 30-day basis from the date of the statement. If we establish a credit limit for a customer, they will not make credit purchases over that amount. They will need to reduce their outstanding balance in order to receive more credit.
7. If a customer's account is over 60 days, we will request immediate payment, or require that they go on a C.O.D. basis until their account is current again.
8. If their account is over 90 days, we will suspend all service and begin collection processes.
9. At 120 days overdue, if there is no remittance, we will proceed with active collection and this will become a part of the customer's credit history.

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Exercise 1 – HAJCO application for credit facilities

An existing client of **HAJCO**, The Rest House Hotel, who has bought regularly from **HAJCO** for the past six months, has heard that **HAJCO** has started to sell on credit to its regular hotel customers. The manager contacts Mrs. Hind and request that her business, also be handled on credit in future.

Mrs. Hind explains that **HAJCO** now uses a credit control procedure and requests the Rest House Hotel provide the following information, so the company can assess whether credit facilities are applicable.

From correspondence and interviews, Mrs. Hind ascertains the following: (please refer to the table on page 123)

- The manager in his own name owns the hotel; he operates as a sole trader with no formal legal structure.
- He has no annual accounts to show, but says his hotel is profitable. He seems to have a comfortable life-style
- He has owned and managed the hotel for the last six months, and during that, time bought fruit juices for J.D. 3,500 per month on average from **HAJCO**, paying cash.
- The manager owns the building in his wife's name, he showed the title deeds, and there is no mortgage on the building
- No credit references were available as the manager deals only in cash; he says he has no bank account.

The credit agency could not provide any financial information on the hotel, but said they had no record of any problems.

How would you rate this client for credit facilities? Within the context of the new policy, how would you handle this situation?

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Exercise 2: HAJCO accounts receivable aging at June 30, 2001

The account balances of two of **HAJCO**'s major customers show the following:
Astoria Hotel unpaid invoices at June 30, 2002 (credit limit J.D. 5,000)

April 22, 2001	Invoice for fruit juices	J.D. 2,350.00
May 12, 2001	Invoice for fruit juices	J.D. 1,850.00
June 11, 2001	Credit note for returned juices	(J.D. 135.00)
June 15, 2001	Invoice for fruit juices	J.D. 1,990.00
June 30, 2001	Outstanding balance	J.D. 6,055.00

George's Guesthouse outstanding items at June 30, 2002 (Credit limit J.D. 675)

March 25, 2001	Invoice for fruit juices	J.D. 655.00
May 15, 2001	Invoice for fruit juices	J.D. 315.00
May 31, 2001	On account payment	(J.D. 500.00)
June 30, 2001	Outstanding balance	J.D. 470.00

You are required to:

1. Draw-up the Accounts receivable aging analysis as of June 30, 2001 for these two customers (as though they were the only customers with open balances at that date).

2. Decide what action, if any, should be apply to each of the two cases, based on the new Credit policy.

3. This is the first time Mr. Jameel has seen such an analysis, based on this sample, what can he do in future to solve his growing Accounts receivable collection problem?

EXERCISE

Look at your most recent balance sheet, what are the most important items in current assets and current liabilities? Based on the ratio analyses you did in chapter 4, are you satisfied with the level of your inventory turns? Is your customer accounts receivable under control; are your day's sales outstanding ratio reasonable compared to your sales terms?

Inventories

Raw Materials
Is your level of raw material inventory sufficient to keep production running smoothly, but not so high that you have losses through theft, deterioration or obsolescence?

Work in Progress
Is your **production cycle time optimised and under control, or do you have excessive** amounts of material in a semi-finished state?

Finished Goods
Is the level so low at times, that it interrupts deliveries to customers, or so high that you have the problems mentioned above of theft, deterioration or obsolescence?

Total Inventory
Does your inventory and production planning ensure that you have the right quantities to keep the business flowing, but without unnecessarily tying up funds you could use better elsewhere?

Accounts Receivable (Debtors)

- Do you sell on credit?
- If so, do you have Credit approval procedures similar to those described above?
- Do you review regularly the overdue balances and have a defined follow-up process to avoid losses through bad debts?

Other **working Capital items**

- Do you negotiate the best payment terms with your suppliers or do you pay faster than you collect?
- Are there other Working Capital items tying up your valuable funds?

4. Chapter Summary

Working capital is the flow of ready funds necessary for day-to-day working of the enterprise. Excessive working capital means inefficient use of the company's funds and risk of losses in inventory and accounts receivable; funds for investing in growth get tied-up in non-productive assets. Insufficient working capital results in shortages of materials for production and finished goods for deliveries, which preclude smooth operations.

Deciding and maintaining of optimum level of inventory investment is critical for efficient inventory management. Excessive inventory leads to unnecessary blocking of funds; inadequate inventory causes delays in production; failure to deliver finished goods on time and additional order cost and transportation cost with the additional risks of theft, degradation and obsolescence.

When credit is, available customers buy more. As a growing business, you may want to advance credit to your customers to help boost sales. However, many businesses extend too much credit to their customers only to find later that those customers cannot pay.

- Extending credit to customers is a business decision. When making a credit policy decision, always weigh the costs and benefits of extending credit to your customers.
- It is important to develop a collection policy before you begin granting credit to your customers. Good collection practices include:
- Monitor the quality of your accounts by regularly computing your day's sales outstanding and performing an aging analysis each month.
- Immediately making and implement a corrective action plan if either of these two items shows an unsatisfactory position.

Monitor regularly other items in the working capital, in particular try to have at least as attractive payment terms from your suppliers as those, you grant to your customers. In this way, your creditors will finance part of your current assets.

5. Make an action plan for credit management in your business

Complete the form below to manage your working capital. The action plan shown in the next page is useful when you prepare your financial growth plan, where you can have a master action plan for all aspects of your financial management.

You can find the forms for preparing your Action Plan in the Financial Management Growth Plan.

ACTION PLAN

OBJECTIVE (What to achieve?)	ACTIVITIES (What should be done?)	TIME FRAME (When it should be done?)		RESPONSIBILITY (Who should do it?)	RESOURCES (How it should be done?)	COMPLETED
		START	END			
						❑
						❑
						❑
						❑
						❑
						❑

ACTION PLAN

OBJECTIVE (What to achieve?)	ACTIVITIES (What should be done?)	TIME FRAME (When it should be done?)		RESPONSIBILITY (Who should do it?)	RESOURCES (How it should be done?)	COMPLETED
		START	END			
						❑
						❑
						❑
						❑
						❑
						❑

Chapter

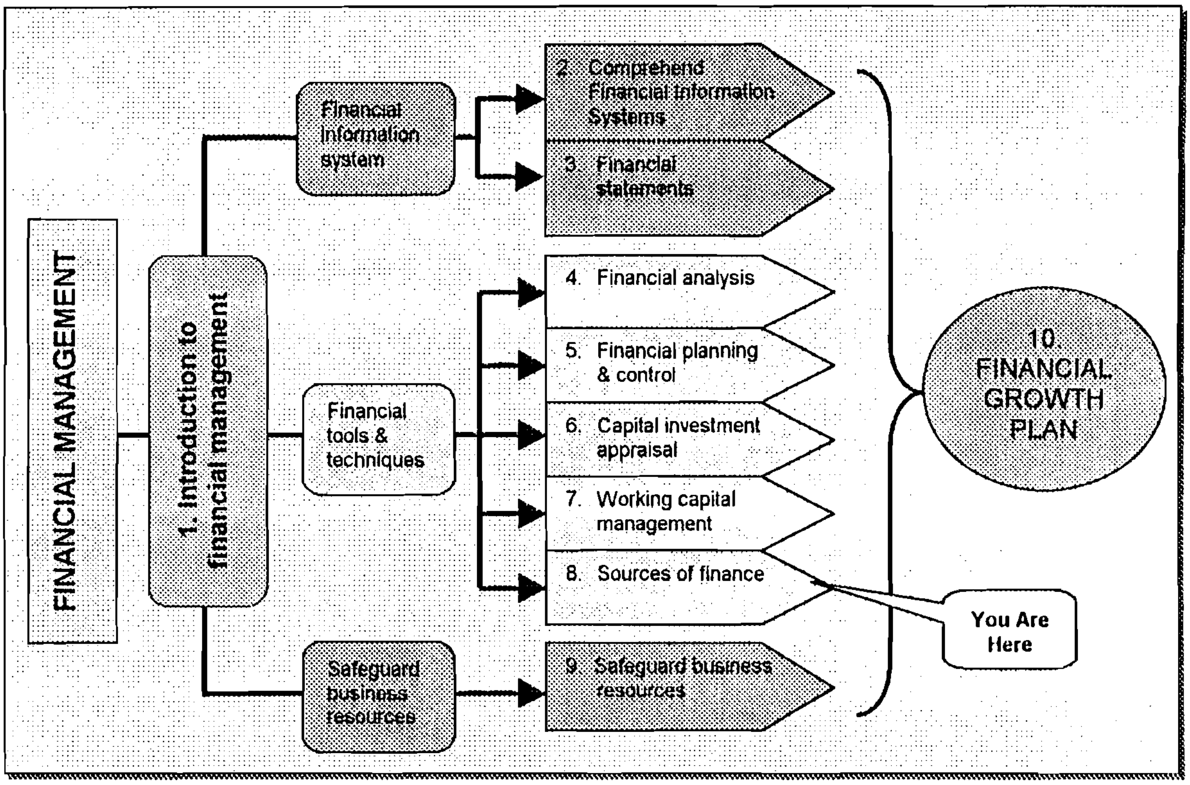
8

SOURCES OF FINANCE

What you will learn in this chapter ...

After studying this chapter, and completing the exercises in it, and with the guidance of your business trainer, you should be able to:

- **Illustrate the principle sources of finance to grow your business.**
- **Explain how proper financing helps you expand.**
- **Estimate how much money you need for your business.**
- **Identify appropriate sources of finance.**
- **Plan for securing the required finance.**

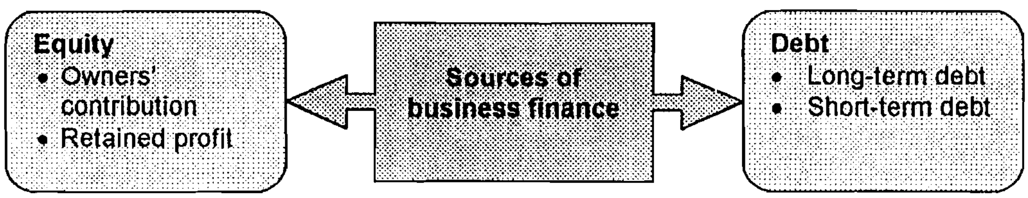


1. What are the principal sources of finance for a growing business?

At the outset, all businesses need financing to get started. Most often, you, the entrepreneur, and maybe some friends and acquaintances invest personally to finance the start-up phase of the business.

As your business grows, you may well need additional financing to buy fixed assets, such as machinery, land and buildings to increase the capacity of your business. You may, also need funds to invest in increased level of working capital, as discussed in Chapter 6.

Some businesses are able to generate some or even all of this finance internally through the business' profits. They are the lucky few. Most companies must resort to some additional sources of finance to meet the investment needs of their business. The following chart summarises the principal sources of business finance into its two main categories of investor funds and loan funds.



This chapter will discuss the critical phases of setting and implementing your company's Financing Strategy, covering the following critical steps:

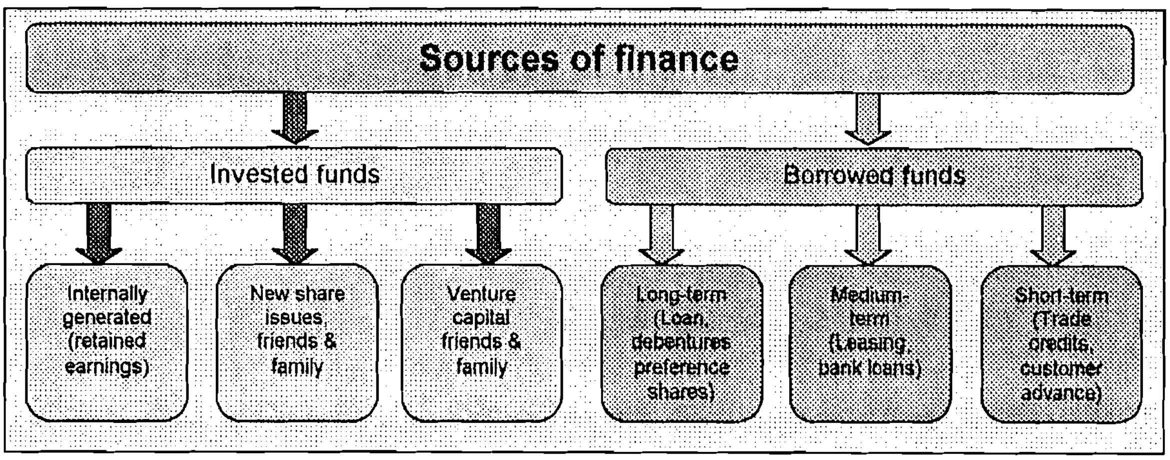
- Quantify the financial needs,
- Identify potential sources of finance,
- Decide on appropriate mix of sources of finance -The financing strategy,
- Actually raising the finances required.

2. How does the use of additional finance help you expand your business?

As discussed in the introduction, fast-growing businesses often need additional financing at a rate faster than the profits of the company can generate. This is not to be seen as negative or a failure on the part of management. On the contrary, it is very positive to see your business growing so fast that you need more financial resources, providing of course that your business is profitable, and that investments in assets are managed efficiently, as detailed in Chapter 6, Capital investment appraisals, and Chapter 7, Working Capital management. Once you have identified this as the case, your problem is to decide the best way for the business to raise the additional capital, whilst protecting the interests of the current owners (the shareholders).Then you will be in a position to seize all the opportunities you can, and continue the profitable growth of the company.

3. Determine appropriate sources of finance, the financing strategy

While many business owners may not think beyond the local bank for their financing needs, the reality is that there are several alternative sources of financing. Bank financing is just one of these, and may be the least desirable form of financing for a small business. Often, other sources of financing are never even considered because, the business owner is too preoccupied with his day-to-day problems to spend time on working out a financing strategy. The following chart summarises the alternatives, you will look at the advantages and disadvantages of each alternative, create a simple model to help you define your strategy.



3.1 Factors to consider when selecting appropriate sources of finance.

Your financing plan should raise funds to your business at lowest cost and lowest commitment and risk. There should be a balance between sources of financing, it should be affordable to the business, and finally it should be an executable plan. Consider the following factors when selecting appropriate financing sources for your growing business:

- **Cost:** if the cost of finance (interest rate + other cost of capital) is higher, you will get lower profit from your business. Compare the cost of each source before you choose.
- **Duration**: consider the nature of your financial requirement, whether it is short term or long-term. As a rule "long term assets should be financed by long-term funds, and short-term assets should be financed by short-term funds"
- **Accessibility**: not all companies have access to all sources of finance. As an example, small companies have difficulties in raising funds through share issues outside the immediate circle of family and friends.
- **Gearing**: gearing is the ratio of debt to equity. Higher debt has the risk of meeting regular repayments of interest and principal. Therefore, there should be a balance between debt and equity. (Refer back to the gearing ratio in Chapter 4), but can be attractive if the investment is in profitable business growth
- **Term structure of interest rates;** this describes the relationship between interest rates charged for different maturity periods. Consider them with the time required to repay your loan.

The first level of decision is whether the additional funding you need is only to bridge a short-term cash shortage, or whether you are looking for long term financing which will enter into the permanent financing structure of the company.

If the need is short-term, naturally you should look to a short-term solution such as a credit line or fixed short-term loan from a bank, or indeed a personal loan to the company by either yourself or close family or friends. In either case, the interest burden must be affordable, and repayment terms easy to meet from operating cash flows within the repayment period.

The real consideration in this chapter is the longer term financing needs, where the first question is whether to increase the amount of shareholder funds by increasing the share capital, or whether to use third-party funds by borrowing or similar mechanisms, which we will consider below, or a combination of both. The basic considerations for this decision are summarised in the following table shown in the next page.

Equity Funds		Borrowing Funds	
For	Against	For	Against
• No repayment	• More own funds or	• No stake in the company	• Repayment dates fixed
• No fixed interest	• Dilute ownership by bringing-in new shareholders	• Can negotiate terms to match needs	• Need to pay interest, even if no profits
	• More people to answer too		• Lender may want guarantees, charges on assets
	• Expectation of dividends		• Lender may impose business constraints

The first conclusion you will reach is that any solution you chose has drawbacks, as well as advantages and that there is no perfect solution. Indeed, to some extent it is very much a question of judgment and personal and cultural factors. Nevertheless, there are some guidelines, which are useful, and some constraints, which will practically limit your choices. So let us look at the alternatives in more detail.

3.2 Consider Your Equity Sources

Owners' equity (owner's capital) is the financing provided by the owners of a business in their capacity as proprietors. It represents the owners' interest in the business. The financial investment you have made in your business is the foundation of the financial structure of the business.

Owners' equity is an important source of financing for every business. Bankers like to see equity in a business as a cushion for any loan they may make to the business. Owners' equity is also money that does not have to be repaid with, nor carry, a fixed rate of interest.

Equity financing has several major advantages for a business. The most important advantage is that, unlike debt financing, equity financing typically does not have to be repaid on any strict payment schedule. Normally, equity investors' compensation is paid to them in the form of dividends, but only when the business has made profits and those profits are not reinvested in the business. This allows equity financing to act as a financial cushion for the business. If the business does not achieve profitability as quickly as expected, or if cash flow is less than planned, you do not have a creditor breathing down your back. After all, it is your money.

In the first place, as with Mr. Jameel, you probably started with your own money or that of close family and friends. As your business grows, you may well want to bring more people into your business and ask them to contribute also, to the capital. This will have the benefit of providing the business with "Free" financing, but will have the drawback that the new participants will want to have a say in how the company is run, and will be entitled to their share in the profits. It is therefore, essential to know fully the motivation of people coming into the company in this way, and to have full confidence in them, as you will be sharing your company with them.

Equity is also the basis for all debt financing. As we will see, when a bank considers making a loan to a business, one of the limiting factors as to the amount of the loan is the amount of owners' equity. The more equity you have in your business, the more debt you will be able to support.

The following table shows some available sources of equity.

Sources of Equity	
Your own personal assets	Most businesses finance their equity from the owner's savings and investments
Profit earned by and retained in the business	The profits earned by the business can be reinvested in the business, rather than being paid out as dividends to the owners
Friends and family	Your friends and family may want to invest in your business because they know and trust you. They may see your business as a good investment opportunity and want to share in the benefits and rewards of being shareholders in your business
Employees or new partners	You may want to attract new managers to your business by offering them the possibility to "buy-into it"; also, you may want to offer this possibility to key employees.
Third-party investors	Institutional venture capitalist or informal venture capitalist may be very interested in buying some shares in your company. Venture capitalists are companies that specialize in providing equity and debt finance to small to medium size companies with good prospects for growth. They will not interfere with the day-to-day but may impose some conditions if their stake is high.

3.3 Consider debt sources

Equity financing is typically the first part in the mixture of financing for your business. Once you have identified your equity sources, you may want to look toward debt sources. Together with institutional venture capitalists, these sources typically involve more formal application processes and credit standards. As you consider these sources, it is important to do some research. You should know and understand how the organizations and their services operate before you attempt to apply to the organizations for financing.

Debt financing may be broadly classified into long-term and short-term sources of finance.

Short-term finance; short-term borrowing has been discussed above. Here we will consider long-term borrowing as an alternative to raising more equity capital for the long-term needs of your company.

Long-term finance; when small business owners first think of financing, they often think of the bank as the first and last source of financing for the business. In fact, there are many sources of financing for the small business. Depending on the circumstances of your business, one or more of these sources of financing may be more appropriate for your business.

3.4 Long term debt financing

- **Commercial Bank financing:** commercial banks offer a wide range of loans to businesses. Commercial banks tend to be the most conservative lenders. However, their loan products tend to provide the best interest rates and terms. The loans can take the form of **Secured loans,** where the bank has the specific right to take over specified assets of the company in case of default on interest payments or capital repayments; the most typical example being a mortgage and buildings owned by the company. Generally, secured loans carry the most attractive interest rates and longest repayment terms. **Guaranteed loans,** These are similar to secured loans in that the bank has a charge on assets, but these will be assets outside the company, which have been pledged as security. The pledged assets may be your own or belong to someone willing to act as guarantor. **Unsecured loans,** banks will also, grant loans without any specific security or guarantee if they consider your business to be sound and low risk, the interest rate will however be higher to cover the additional risk compared to secured or guaranteed loans.
- **Other lending institutions**: as well as banks, there are other financial institutions, which lend money in similar ways to those described above. They can vary from State-run organizations set-up to encourage business start-ups, which can be very attractive, but can impose conditions on how the business must be run. To private individuals in your own environment who may be prepared to help out and get a bit better rate than they would on bank savings; to the extreme case of "Loan sharks" who will charge exorbitant interest rates and have no sympathy if you run into any kind of difficulties. In all of these cases, be extremely careful WHO you are dealing with, and on what TERMS. If necessary, get your lawyer to set-up a proper loan contract.

The first attraction of borrowing, as opposed to raising Equity capital is that eventually you will repay the loans without having diluted your ownership of the company, and any commitments, such as charges on the assets and interest payments will cease. Additionally, though there is the attraction of what is called 'leverage'. The advantage of 'leverage' is that you will use the borrowed money to earn more profits. The extent to which those profits are higher than the interest cost is extra profit for you, without you having invested more money. If Mr. Jameel adopted this approach for his financing needs as shown in the following case study you could see:

CASE STUDY

Hanna Juice Company (HAJCO) Ltd.

Example 1

		Case 1	**Case 2**
		Increased capital	**Borrowing**
In thousands of JD			
Equity at June 30, 2001		520	520
Additional financing:			
Capital increase		100	
Share capital		620	520
Original borrowing		260	260
Borrowing at 23%			520
Borrowing		260	780
Total Financing		880	1'300
Return on Invested capital,			
Before interest	50%	440	650
Interest	23%	60	179
Net profit		380	471
Return on Equity		**61%**	**91%**

In **Case 1**, you see that Mr. Jameel could raise only J.D. 100k new capital and did not want to borrow. His business' profitability is limited, because he could not build the complete production facilities necessary to meet the demand.

In **Case 2**, Mr Jameel could raise no more personal capital to invest, but borrowed the full amount he needed from the bank. By borrowing at an, albeit high, rate of 23%, the company invested the money in new site and equipment which generated business making a 50% return on the investment (this is actually conservative as 2001 gave a 73% return on investment!).The additional 27% (50-23) all goes to **HAJCO** with no additional investment whatsoever. This is called leveraging the borrowed money. However, as with all opportunity, there is risk. In this case, the shareholder, Mr. Jameel, takes all the risk as the bank gets its interest whether the profits are realised or not. If the high profitability is not sustained, you could see this scenario:

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Example 2

		Case 1 Increased capital	Case 2 Borrowing
In thousands of JD			
Equity at June 30, 2001		520	520
Additional financing:			
Capital increase		100	
Share capital		620	520
Original borrowing		260	260
Borrowing at 23%			520
Borrowing		260	780
Total Financing		880	1'300
Return on Invested capital,			
Before interest	12%	106	156
Interest	23%	60	179
Net profit		46	(23)
Return on Equity		7%	-5%

Here, you see that if the profit rate (12%) drops below the borrowing rate of 23%, the company will not make sufficient profits to cover the interest. The interest is nevertheless due, as it is not dependant on the company making profits.

The **conclusion** to this demonstration is that, for a profitable business, leveraging borrowed capital can be attractive, but the risk must be managed. If the Return on Equity of your company is less than or only slightly more than, the borrowing rates **DO NOT ENVISAGE USING LEVERAGE!**

In reality, reputable lending institutions are unlikely to lend beyond a reasonable level of risk, and you are advised not to allow your borrowing to exceed your own invested funds. Naturally, as the business earns profits and these are reinvested, your invested funds will increase, as well as your borrowing capability. It is critical to be conservative in the Capital Investment Appraisal [described in Chapter 6 (Net Present Value – NPV)] to set the required Return on Equity rate sufficiently high to cover the loan interest rate [and to leave a good margin for the shareholders (e.g. if the bank lends at 15%, the investment must earn 25% or more)].

In the example above, Mr. Jameel decided that he can invest a further J.D.50k of his own money and will keep his borrowing to 45% of the total funds invested, including the existing loan.

This gives the following capital structure:

Example: HAJCO increased capital structure				
In thousands of JD				
	June 31, 01	Additional capital	New structure	
Equity	520	50	570	
Loans	260		**466**	**Borrowing limit**
Rounding		210	4	Rounding
			470	Borrow
Total Invested funds	780		1'036	=570/ (1-45%)
		Rounded	1'040	
Gearing ratio			**Target**	
(Loans % Total)	33%		**45%**	

Based on the above, Mr. Jameel felt putting-in J.D.50k of his own money and borrowing a further J.D.210 is a reasonably safe strategy. He tested this in the model above as follows:

Example: HAJCO impact leverage on borrowed funds - Example 3				
In thousands of JD				
		Case 1 Profit @ 50%		Case 2 Profit @ 12%
Equity at June 30, 2001		520		520
Additional financing:				
Capital increase		50		50
Share capital		570		570
Original borrowing		260		260
Borrowing at 23%		210		210
Borrowing		470		470
Total Financing		1'040		1'040
Return on Invested capital,				
Before interest	50%	520	12%	125
Interest	23%	108	23%	108
Net profit		412		17
Return on Equity		72%		3%

Mr. Jameel then reasoned:

- He can mortgage the new building at better than 23% interest, thus bring the average interest rate down to something close to 20%
- He used 50% return on Equity in the model, but the rate in 2001 was 73%. He knows this will come down over time, but not this fast, so 50% was conservative and 12% very pessimistic.

He therefore, concluded that the financing strategy outlines above was not risky and had further potential to help his business to grow.

> **If you are in an environment where interest rates are very high, this model is still valid, but the profitability rate must be set VERY high to make the investment and loan a reasonable risk.**
>
> **As a rule IF IN DOUBT, DO NOT!**

In addition to Bank loans, there are other financial tools to consider. They are unlikely to be cheaper than secured or even unsecured bank loans, but may be a good complement if your borrowing capacity is limited.

3.5 Debtor account financing and factoring

when you sell to customers on credit (open account), they promise to pay you for the goods and services you provided within a certain date of delivery. This can put a huge strain on the working capital of your business. Sometimes you cannot wait for your customers to pay you back. However, if your customers are very well established companies, or government organizations, you may be able to sell these accounts to your local bank or another company that specialises in purchasing debtor accounts. Typically, this is an expensive form of financing where the buyer will pay for the accounts at a steep discount. On an annualised basis, debt-factoring discount rates equate to very high interest rates. However, if you need the money, it may be worth looking into factoring (selling the accounts) and ploughing the money back into the business.

3.6 Hire purchase, operating lease and finance lease arrangement

This kind of financing is related to a specific asset purchase, such as machinery or vehicles. You may want to acquire a specific asset for your business, your alternatives are:

- **Hire purchase;** this is an arrangement whereby you can get the use of a piece of equipment or a vehicle over a specified period of time, without having to pay cash up-front to purchase it.
- **There are two types of Hire Purchase agreement:**
  - **Operating lease**: under this type of contract, there is no purchase option at the end, the item must be returned to the owner. You never own the equipment, but may of course make an offer for it at the conclusion of the lease, but will pay the market price.

- **Finance lease;** a finance lease is a lease arrangement that transfers substantially all the risks and rewards associated with ownership of an asset from the original owner to the lessee. Under finance lease, the lessee is only required to pay a relatively small deposit in advance to obtain the equipment. Over the term of the lease, regular payments are made to the financial institution or equipment dealer. During the leasing period, the legal title to the equipment resides with the original owner. When the lease term expires, the lessee usually has an option to take legal title to the equipment when all lease payments have been made. If however the lessee defaults on payments, the owner is entitled to retake the item leased without any compensation, the lessee forfeiting all payments made to date.

Businesses can borrow from either Commercial banks with competitive interest rates or equipment dealers, hire-purchase finance companies whose rates are not as preferential. Nevertheless, these arrangements can be attractive in specific circumstances; for example, automobile manufacturers often offer very low or zero interest rates to stimulate sales.

Always check with your bank for a more competitive offer before entering a hire-purchase agreement.

3.7 Credit cards

In the past, credit cards were rarely used by businesses for anything but travel and entertainment expenses. However, today credit card companies have become very aggressive, and companies are able to obtain competitive financing for business expenses, including equipment, through this method.

4. Planning for and actual raising of required finance

4.1 What Information Will Be Required

When you go to financial institutions to apply for financing: Venture capital or a loan, information will certainly be required from you. You should have this information compiled in a professional manner before you go to apply for financing

You should be organised and prepare well with your materials. The lender may have questions regarding the information you provide. It will help gain his confidence if you are well prepared to answer the questions completely. If you appear well organised in your meetings, the lender will feel that your business is well managed. However, if you come to the meeting ill prepared, with incomplete information, the lender could assume that your business is in a similar state of affairs.

You may be required to provide most or all of the following items of information:

- **Loan Application;** you may get a copy of the banks loan application form in advance of your appointment with a loan officer. You should complete the application form before your meeting, and include it in your package.
- **Income Tax Returns;** income tax returns may be required for you and your business in respect of the last three years.
- **Financial Statements;** you will be required to produce the balance sheet and income statement (profit and loss account) for the last three years.
- **Strategic and Financial plans;** all lenders and investors will ask you to explain your business with financial projections. If you have done a good job preparing your Strategic plan, your Strategic Finance plan, your Operating Capital and Cash budgets as outlined above, you will be well placed in this area.
- **Curriculum Vitae (or Résumés);** you should include CV's (resumes) of all owners and managers. The bank wants to see who is running the business, and know about their experience and education.
- **Collateral security list:** You should include a list of all assets, both business and personal, that are available as collateral to secure the bank loan. The list should include approximate market value of the assets listed.
- **Copies of Articles of Incorporation or Partnership Agreements;** the bank will require all the legal documents that address the legal form of your company.
- **Contracts, leases and other legal obligations;** all the significant legal obligations that can affect your business's ability to pay the loan will be of interest to the bank.

Remember, when working with a lender, it is important to provide complete and accurate information in a timely manner. If you delay responding to a request for more information, it will only slow down the entire process

4.2 Effective Presentations for Securing Financing

In finance circles, the key elements of credit that the lender will be most concerned with are referred to as the **5 C's of Credit**. Your loan application should thoroughly address these factors.

The five C's of Credit

- **Capacity (management)**: the ability of the borrower to repay the lender depends on its profitability and liquidity. No banker, lender or investor will place their money in the hands of someone if they do not think it will be repaid. Cash flow from the business is the ultimate source of repayment. You should develop realistic cash flow projections, based on reasonable assumptions, which clearly demonstrate your ability to repay with interest.

- **Capital:** the lender will expect that there is enough owners' equity or capital in the business to support the loan. As a rule of thumb, the equity should be no less than 15-25% of the amount required. This varies with industry and your ratio may be different. Discuss it with your lender.
- **Collateral**: collateral is known as the secondary source of repayment. It can take the form of any kind of asset including cash, accounts receivables, inventory, equipment, buildings and land. Often the assets of the business are not sufficient to cover the loan balance. In that case, the lender will look for additional collateral from sources outside the business, including your personal financial assets.
- **Character:** your lender will want to know if you have a record of accomplishment of repaying your bills on time. The lender will request credit references to verify your repayment history. If you have had problems repaying past debt, do not hide them. Let the bank know up-front, that there is such a history.
- **Conditions**: In evaluating the application for finance, a lender takes into consideration the general economic and business conditions as well as the unique circumstances affecting the applicant or lender.

Important

If you are in an environment where interest rates are very high, this model is still valid, but the profitability rate must be set VERY high to make the investment and loan a reasonable risk.

4.3 Make a convincing case for your loan

It is up to you to sell the fact that you are a good risk for a business loan. Develop your case along the critical **5 C** factors. Be sure that you have adequately addressed the issues in your loan application.

Some common reasons for loan denials include:

- Insufficient cash flow to support loan repayment;
- Lack of management experience;
- Poor track record of repaying past debts;
- Lack of collateral;
- Ratio of debt to capital too high;
- Insufficient information or incomplete package;
- Inability to defend your proposal as it is written by another person. Understand the information you submit, even if you had a consultant develop it for you. Be prepared to defend it.

EXERCISE

1. Take your Strategic plan (See the Strategic Management Module and your Finance plans as described in Chapter 4 of this Module, and be sure that the financing requirements are clear and make sense. You will need to be able to argue your case based on these.
2. Determine the sources of money currently available to you to cover these needs. The funds already in the business (from the Balance sheet), what additional funds you may be prepared to invest, and what other private capital you may be able to access.
3. Apply the information into the financial strategy model, be CONSERVATIVE with your estimates of profitability and cash generation. Decide, for yourself, what is the maximum risk you can safely take.
4. Complete the Financial Strategy models per the examples for HAJCO shown on pages 139-141 to assess your borrowing power in relation to your current level of profitability. Do some simulations to see the effect of increasing or reducing levels of profitability and debt leverage to get a feel for your own business' potential.
5. Shop around the banks and other finance companies, check if there are any government or International funds available (such as World Bank, European Union sponsored development funds etc). Show your file to all of them, and make sure you get the best deal.
6. FOCUS on making your business perform as planned, it is the only way to cover interest and repay loans on time!

5. Chapter Summary

Use your Strategy Plan; your Strategic Finance Plan: Your annual budgets to determine what financing you need – How much and for how long.

Determine your short and long-term needs and set a conservative strategy. How much of the company's and your own and private funds can you count on. How much can you borrow safely without jeopardising the future of the business? Test this out with the Finance Strategy (Gearing) model. Are you with reasonable safety limits? Have you been conservative in your approach?

- Consider your equity sources. Equity financing has several major advantages for a business (but can also dilute your ownership!).
- There are many forms of financing. You should explore all the different forms of financing, and determine which ones best suit the needs of your company.
- When you apply for business financing, be prepared. Certain information will certainly be required from you. If you appear well organised in your meetings, your lender will feel that your business is well managed.

- Your finance application should thoroughly address the 5 C's of Credit: Your lender expects that your business will have some weaknesses. Be realistic about the potential of your business, you will have to live up to whatever you promise.

6. Make an action plan for identifying sources and securing finance for your business

Complete the form below to assess the sources of finance and secure financing requirements for your business. The action plan shown in the next page is useful when you prepare your financial growth plan, where you can have a master action plan for all aspects of your financial management.

You can find the forms for preparing your Action Plan in the Financial Management Growth Plan.

ACTION PLAN

OBJECTIVE (What to achieve?)	ACTIVITIES (What should be done?)	TIME FRAME (When it should be done?)		RESPONSIBILITY (Who should do it?)	RESOURCES (How it should be done?)	COMPLETED
		START	END			
						❑
						❑
						❑
						❑
						❑
						❑

ACTION PLAN

OBJECTIVE (What to achieve?)	ACTIVITIES (What should be done?)	TIME FRAME (When it should be done?)		RESPONSIBILITY (Who should do it?)	RESOURCES (How it should be done?)	COMPLETED
		START	END			
						☐
						☐
						☐
						☐
						☐
						☐

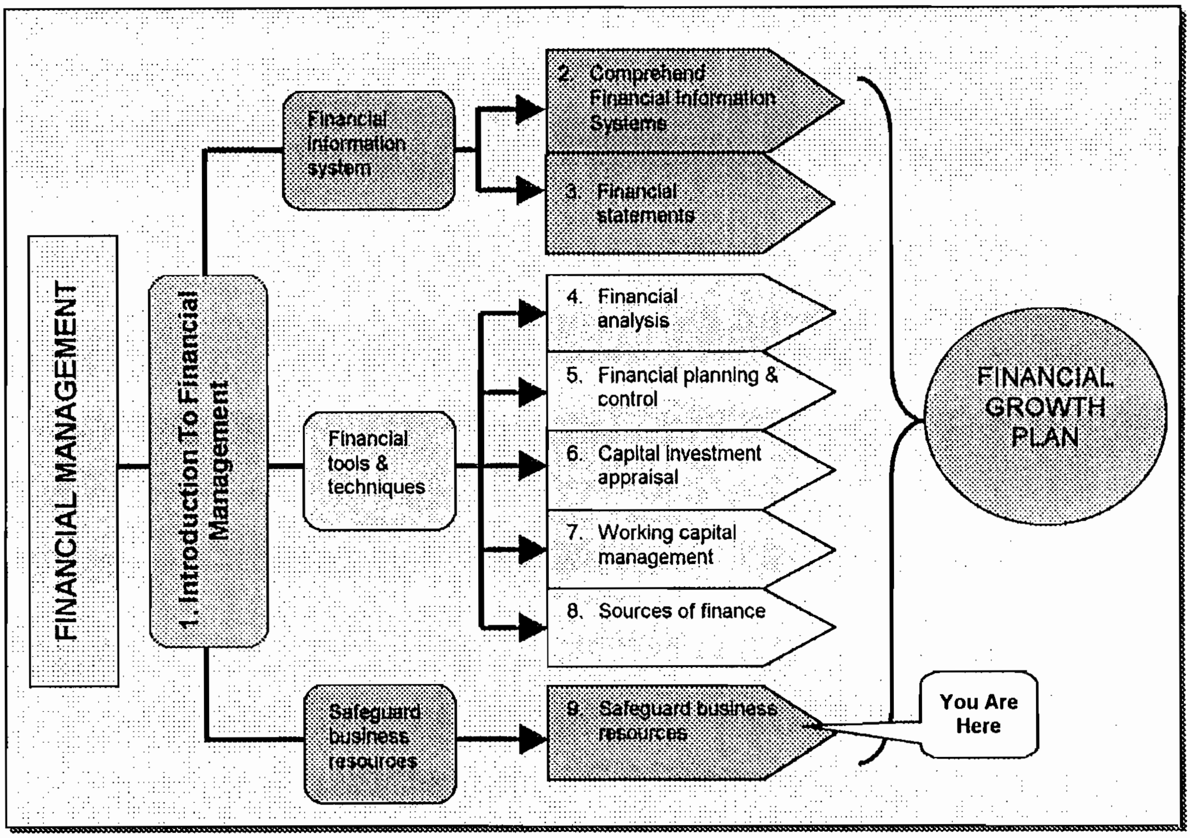
Chapter 9

SAFEGUARD YOUR BUSINESS

What you will learn in this chapter ...

After studying this chapter, and completing the exercises in it, and with the guidance of your business trainer, you should be able to:

- Identify the aspects involved in safeguarding your business.
- Illustrate how safeguarding your business helps you grow.
- Safeguard your business.
- Explain the need for internal controls.
- Prevent burglary and robbery.
- Deal with family business.



1. What aspects are involved in safeguarding business resources?

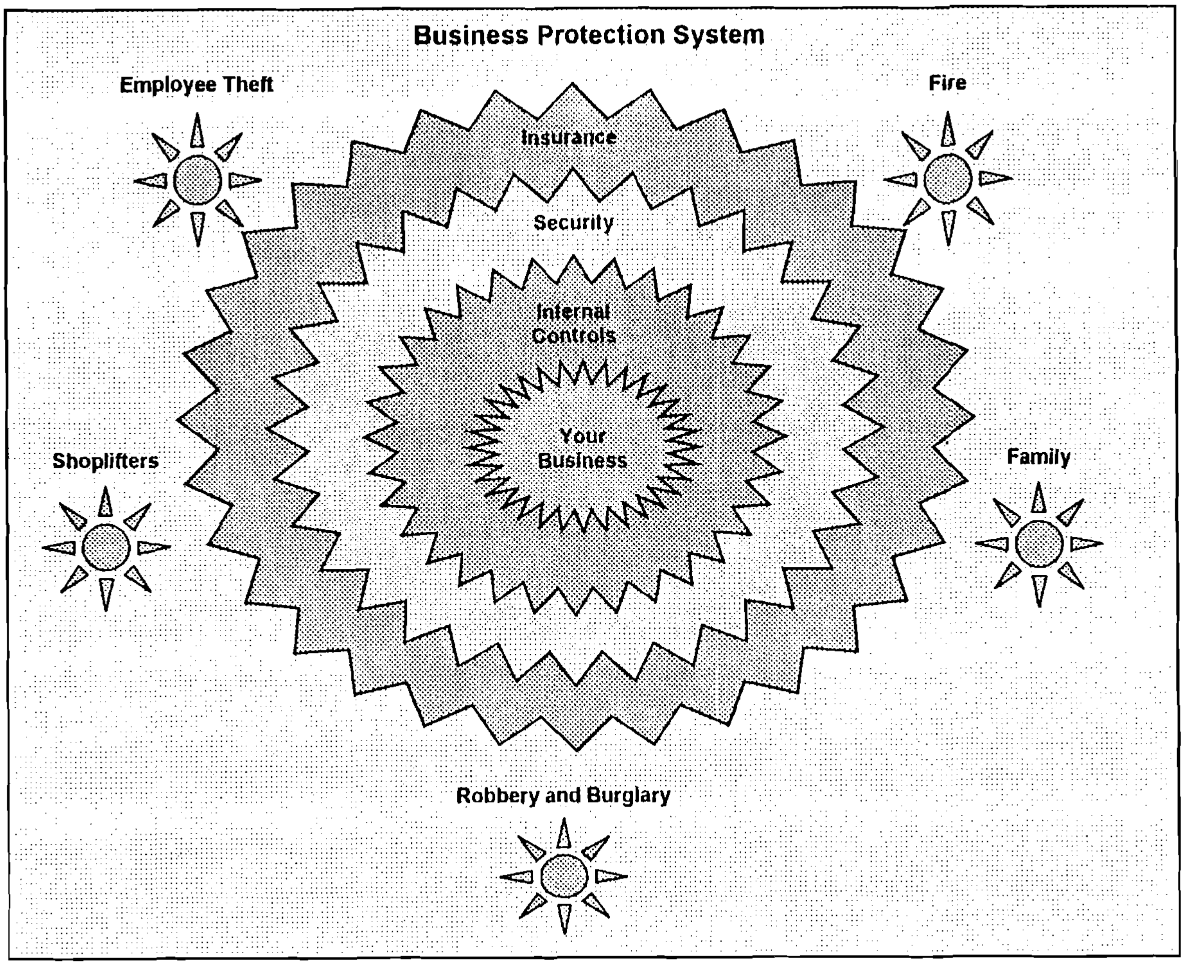
Your business represents a very significant financial investment. In fact, it may be the single largest investment you make. It probably is, also, the main source of funds for your livelihood. Any loss to your business, through negligence, natural disaster, fire, embezzlement, fraud, theft or robbery affects you directly.

When your business was small, you probably had the time to monitor every aspect of your business operation. You knew all your employees well, and you had direct involvement in the day-to-day operations of the business.

Important

As your company grows, so will your responsibilities. You will be required to delegate more responsibility to your employees, and you will not be able to monitor the people around you so closely.

Think of your business as a village; the village needs protection. As *chief of the village*, it is your responsibility to establish a system of protection for the village against internal and external threats. Internal controls are one line of protection and security is a second line. The final line of protection is insurance. These lines of protection will protect your business against threats: employee theft, fire, robbery and shoplifting, as well as, simple negligence like forgetting to invoice goods delivered to a customer.



The Expand Your Business: Strategic Human Resources Management Module introduces tools and techniques to help you recruit, train and motivate your staff. The Strategic Management Module also provides information to help you establish systems to delegate responsibilities to your growing staff.

This section of the **Financial Management** addresses the potential areas where you are most likely to suffer loss. As you grow your business, it is important to identify potential vulnerabilities and take action to minimise risk and loss.

This chapter will focus on these key areas:

- Internal business controls
- Prevention of Employee Theft
- Prevention of Burglary and Robbery
- Prevention of Shoplifting
- Insurance Coverage to safeguard assets
- Family and business

Each of these areas presents specific risks to an expanding business. This risk has to be controlled, or the expansion plans of your business can be de-railed by financial losses that could probably have been avoided or minimised.

2. How do safeguarding business resources help your business expand?

Close your eyes, and imagine what you would do if your business was destroyed by a fire. Think about what would happen if the person you thought were your best employee turned out to be the best thief you ever knew, and stole the entire monthly payroll from your business. If you are a retailer, you probably already know about the losses that you incur when people steal merchandise from your business. You may have family involved in your business; think about the disruptions this could cause to your business if there was a major disagreement within your family that caused the business to be shutdown.

For a business to grow successfully and implement expansion plans, it is necessary that the business establish specific systems that safeguard business assets. Many businesses that should grow and become successful companies end up failures, as they do not have proper systems in place to protect the business against common mishaps and disasters. This is because the owners of those businesses think that to grow their business into a large and successful company it takes only clever and creative products, and aggressive marketing plus adequate capital. It turns out that while these things are necessary, it is also, important to take precautions against events that could seriously disrupt the growth of your business.

3. How to safeguard business resources

One of the reasons many businesses do not bother to take measures to safeguard from threats is that they are so busy with the day-to-day running of the business that, they do not think about what they need to do to protect the business. Often business owners will say, "What can I do if my employee steals from me? Alternatively, if my business burns down? I will just have to start over again and try to survive." This approach is very erroneous. The fact is there are many things that a business owner can do to help prevent or minimise the common problems that can cause such financial losses.

In this section, you will learn about the problems that businesses face than can cause serious disruptions to the business expansion. You will also learn about reasonable, affordable and reliable methods to implement and safeguard your business assets, and help you stay on track as you implement your business expansion plans.

EXERCISE

1. On the chart below, in column one, make a list of all the potential threats to your business. In column two, make a list of your protection against these threats.

Threats	Protection

2. How many threats to your business did you identify? Do you have a defence for each of these threats? If not, what defence can you put in place to counter the threat?

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Preliminary list of potential threats:

Mr. Jameel went through a similar exercise. He realise, that the list may not be exhaustive, but went surprised how many risks there were and how many he really had not implemented any form of protection. Here is an extract from his list, highlighting some of the major common risk areas:

Threats	Protection
Factory	
Fire,	Insured against all physical loss and damage and loss of earnings – but_**need to check if cover adapted to business growth**
Robbery (with break-in)	Burglar alarms on windows and doors, insured against loss of property and loss of earnings
Theft (without break-in)	**Not considered risk of theft from inside by employees or collusion of employees with outsiders**
Threats	**Protection**
Dispatch and distribution	
Fire, robbery, theft	As above
Are all deliveries actually invoiced?	Aware of risk but trusts his drivers who load and deliver – **Had not considered billing process breakdown or loopholes allowing goods to be delivered but not billed, collusion between deliverers and customers.**
Office	
Liquid cash in till form customers and petty cash	All kept in the safe, only Mr. Jameel & Mrs. Hana have keys. Customer receipts in cash, banked daily – **But drivers can collect cash from customers, they pay it over to Mrs. Hana, for banking, but controls are weak.**

The following is a list of typical incidents, which occur to business not well prepared to deal with them:

- **Cash**

One scheme involves the employee taking cash without making a receipt of the transaction. Unless you have a system of controls in place, this is very difficult to detect. Spot checks and other monitoring procedures can be used to help prevent this type of embezzlement.

- **Receipts**

  Another scheme that is somewhat more complicated involves the temporary withholding of receipts, such as payments on accounts. Money is taken against the receipt and made up for with another, second receipt.

- **Cheques**

  In this case, an employee will use the time lag from when a cheque is deposited in a bank to pull cash out of the company's bank account. This type of fraud requires at least two bank accounts, one being the employee's and the second for the company.

- **Payroll**

  Employees may add fictional or deceased friends or family members to your payroll.

- **Purchases**

  An employee may set-up a fictional company to supply your company with goods or services. Of course, the payments end up in the employee's pockets.

- **Computer Based Crime**

  Computers are changing the way small companies operate just as they are changing the rest of the world. Computers allow companies to perform common business operations quicker and much more efficiently than ever before. However, computers also bring extra risks to a company.

3.1 Internal Controls

Internal controls are the controls that you establish within your business to ensure that no one in the business has too much access to business assets to easily steal or defraud your business, or even through oversight or incompetence cause the business to lose money. Many businesses are often the victim of criminal activity or negligence within their organization because they allow people too much freedom. Maybe you have someone who handles a large quantity of cash on a daily basis. Alternatively, maybe the people who work in your stock room are able to steal without your knowledge. Maybe you deliver goods or services to customers, but never bill them through either poor processes or fraud. You need to take precautions so none of your workers can easily steal without being caught or make mistakes, which cost you money.

Embezzlement and Fraud are very common forms of employee theft. Employees that have access to key assets or records can take advantage of this, and use it to steal from you. Embezzlement and fraud comes in many forms.

EXERCISE

Make a list of the possible ways your employees can steal money from you. What actions will you take to help prevent employees from stealing from you?

Computers bring new risks!

You have probably heard of computer hackers and computer viruses. The reality is that the very computers you depend on to help run your business can be used against you to damage your business.

Example of Risks:

- **Unauthorised access to confidential information;**
- **Destruction of key business data;**
- **Alteration of financial records for fraud;**
- **Unauthorised use of computers for personal gain;**
- **Theft of computers, data or programmes.**

As you work with your accountant to develop a system of internal controls, include your computers systems in your efforts.

■ Action required

To prevent or minimise problems with fraud and embezzlement, it is essential to have your accountant set-up a good system of internal controls. This system of internal controls should also include separation of duties. Most fraud schemes are easily defeated if employees are not allowed too much authority over too many transactions.

There is a wide variety of things you can do to double check on your employees. An accountant can work with you to develop methods to double check on employees.

A few examples of methods are:

- **Assignment of Responsibility:** responsibility and authority for given functions and tasks should be clearly assigned to an individual or group. This avoids duplication of effort and insures that if the job is not done, responsibility can be assigned, or if the job is done well, the good work can be praised
- **Division of Work:** no one person in the firm should be responsible for all aspects of any related transactions. For example, the person who authorises purchases should not also be the person who authorises payment of invoices. Two people should be used for this function. This makes it harder for one person to steal and helps detect errors and omissions.
- **Separation of Accountability**: custody of assets is maintained separately from record keeping. The person who is physically in-charge of stocks should not, also maintain the stock records.
- **Adequate Records**: a business grows it becomes more complicated; it is easy to loose track of equipment and other assets. If the company keeps good records, it will be easier to track assets, and discover if things are missing. Poor records are an invitation for employees to steal. If you do not keep track of it, you will not know it is missing.
- **Rotation of Personnel:** if people become very secure in their position, they may become careless, or worse they may find ways to defeat your control systems and steal. If you rotate personnel, they will not be able to become overly comfortable in their positions. Carelessness and dishonesty will become easier to discover.
- **Internal Auditing**: larger companies have internal, independent auditing departments. Internal auditors attempt to uncover waste and inefficiency, and make recommendations to management to improve operations. A smaller company may wish to contract this function out. However, you do it, it is important to have an "outside" unit regularly monitoring the operations of the business.
- **Physical Protection of Assets** :this is the simplest and most important method to reduce risk of loss. Protection may include locks, hidden cameras, security guards and alarm systems. Additionally, every business should maintain adequate insurance coverage for fire and outside theft.
- **Cash Controls**: do not keep excess cash around! This includes cheques, money orders and order negotiable instruments. Deposit cash receipts into the bank on a regular (minimum daily) basis. Cash that must be kept on site should be held securely in a safe

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Risk of employees stealing money

Following-on from the list of Threats in the previous exercise, Mr. Jameel saw that allowing his delivery drivers to collect cash from the customers was a potential risk. He therefore, decided to investigate a little further and was shocked s to what he found. He believed that by sending statement of account each month to his customers, any cash collected but not paid-in would immediately be spotted and notified by the customer. He decided nevertheless to get a friend to follow discretely the driver and check how he operated. The friend came back with the following comments:

- No control over the number of cases of juice the driver loaded onto the vehicle; he simply loaded from the depot.
- Most customers signed for receipt rather than paying cash. They would be invoiced later on 30-day payment terms. However, two customers paid cash. In one case, no paper work was exchanged at all. In the other, the driver gave a receipt.
- On return to the office, the driver handed-in some cash, but not the receipt book. On enquiry, the friend discovered that the book was handed in only once per month to update the accounting.

The friend suggested to Mr. Jameel that this all seemed very suspicious, and that it looked like a case for the police. To him it seemed possible that:

- The driver was delivering material not recorded, as going to the customer and pocketing the cash,
- The driver was not handing over immediately all the cash for which he gave receipts, but using some during the month for his personal needs, and paying-in the difference by month-end (called teeming and lading).

Despite his disappointment that his trust was misplaced, Mr. Jameel did call in the police who investigated and did indeed find that these frauds were taking place.

As you saw in the **HAJCO** example previous, it is very easy for errors and fraud to occur if inventory controls are weak. It is essential that all movements in and out of inventories be subject to properly approved, pre-numbered documents with copies sent directly to the accounting department. In addition, no goods should leave the premises without being checked at the exit gate to ensure that the goods on the vehicle correspond to the paperwork. Additionally, drivers should either not be allowed to collect cash or, if this is unavoidable, they should handed in the cash each evening, and someone should check that it corresponds to the receipts.

3.2 Employee theft

Many businesses find that the greatest potential crime threat comes from their own employees. You may think that your employees are honest and loyal to you and generally, that is the case, but under certain circumstances, employees can become your greatest threat. You, probably, will not be able to eliminate the threat of stealing. However, you can install certain control procedures that reduce the temptation and make it more difficult for your employees to steal.

Hiring quality people is the first and most important thing you can do to reduce the risk of employee theft.

Do not give new employees too much authority or access to key business resources until you have enough experience with them to know you can trust them. Over time, you will get to know your employee, and you will be able to allow them more autonomy and access to the business.

The Expand Your Business: Strategic Human Resources Management Module discusses ways to select, interview and hire new employees. By hiring quality people, you will avoid many problems and reduce the incidents of employee theft.

Rules That Can Help Eliminate Employee Dishonesty

- When possible, turn thieves over to the police. When you let people off with an apology, they see that nothing bad will happen, and it invites more dishonesty.
- Permit only authorised employees to set prices and mark merchandise.
- Rotate security guards. When guards are rotated, it is harder for them to co-operate with thieves. It also helps to cut down on boredom. A guard will get bored doing the same things repeatedly.
- Make a dependable second check of incoming materials to avoid collusion between drivers and loading dock personnel. Do not let trucks and drivers hand around the loading dock.
- Do not allow drivers into the loading area. Consider installing closed-circuit television cameras to monitor the loading dock. Have the receiving supervisor's desk or office positioned, so he / she has an unobstructed view of the loading area.
- At the loading platform, do not permit drivers to load their own trucks, especially by taking goods from stock.
- Make sure that every lunch bag, toolbox, a supervisor or guard inspects brief case or other bag before leaving the premises.
- Control all keys carefully. Do not leave keys hanging on the wall where they can easily be borrowed and duplicated by a dishonest employee, while they are on break.
- Supervise trash pick-ups, and inspect disposal locations to prevent employees from colluding with the trash disposal worker.
- Control receiving reports and shipping orders carefully by sequential numbering to avoid duplicates, fraudulent reports or padding or destruction of shipping orders.
- Make sure that receiving reports are prepared immediately after receipt of a shipment. This helps avoid theft and record-keeping errors.

EXERCISE

1. Do you have any systems and controls in place to prevent employee theft?

2. Did you carefully screen all of your existing employees before you hired them?

3. Where in your business do you think you are vulnerable to fraud and embezzlement?

4. Do you use computers in your business? If so, have you developed systems to prevent computer-based crime

3.3 Prevention of Burglary and Robbery

While your employees can present an important risk for your business, there are many more threats that come from the outside. As it is important for you to protect against internal threats, you must, also take into account threats from outside the business.

Burglary and Robbery can be a major source of loss for many businesses. These losses are preventable by taking care to implement a few key measures.

- **Locks**: quality locks are very important for security of your business. Although a potential burglar can break all kinds of locks, they can deter the crime by making it more difficult. Make sure a professional locksmith installs the locks. Improper installation of a lock can reduce its effectiveness and increase your risk of robbery.

Important

Control your keys carefully!

Do not allow employees to duplicate keys. Keep records of who has possession of what keys. If an employee leaves with your keys, you must replace all of your locks. Take a periodic inventory of all keys to make sure they are not lost or lent out.

- **Alarm systems**: alarm systems are very effective in preventing burglary. There are many types of alarm systems available in the market place these days, and they are not as costly as they used to be. You should seriously consider installing an alarm system in you business. Because alarm systems are highly complicated, you should contract with a professional security company who will design, develop and install an alarm system for your business.
- **Adequate indoor and outdoor lighting:** lighting around the outside of your building can be an effective deterrent to many potential burglars. The lighting should be set up to eliminate any dark areas where a burglar can work unobserved. Indoor lighting is also important for businesses that have windows. By lighting up the indoors, burglars can be seen through the windows by police or anyone passing by.
- **Protection of Windows, Doors and Other Points of Entry:** heavy window screens iron grating or bars are a good way to protect windows. They are useful on windows that are especially vulnerable to robbery such as those in the back of the building and those at street level.

For the front of the business, it is more attractive (and more costly) to have movable screens that can roll or slide out of the way when the business is open, and put back in place when the business is closed.

Window bars and screens can be a major hazard if people cannot exit the building in case of emergency, especially fire. Be sure that all fire codes are implemented and that people cannot be trapped in the building.

Be sure to consider other points of entry such as skylights, ventilators, roofs and roof hatches. Check to see that they are secure as you would windows and doors. Roof material is sometimes light and can easily be cut or broken to gain entry. If necessary, reinforce the roof to provide additional security.

- **Private Security Patrols**: private security patrols are available and can add an additional level of security to the business. Be sure to check the references of any private security firm you hire. Check to see that they are reliable and properly equipped.

As a business owner, you are seen as a good target for a robber because you are successful and you may have money. Your business is a target for the same reason.

There are several things that you can do to reduce the risk of robbery: if a robbery happens, reduce the risk of personal injury.

Train your employees: make sure that they know what to do if a robbery happens. Tell them it is important to protect their lives. Robbers can be very dangerous. No one should feel the need to be a hero.

Instruct your employees not to resist the robber, stay calm and make mental notes of the criminal to provide an accurate description to the police when they arrive.

- **Do not have excess cash:** excess cash invites a robbery. Your cash should be deposited in the bank on a regular basis. When taking cash to the bank, do so during the day when the streets are busy and there is less chance for you to be robbed. If necessary, use an armoured car service.
- **Opening and closing:** there should always be at least two people around for opening and closing the business. Opening and closing times are popular for robberies because fewer people are around. Two people, working together, can help prevent problems during these times. One person can act as a look out, while the other performs the opening and closing procedures.

3.4 Shoplifting

Shoplifting: when customers steal merchandise from you while they pretend to be shopping. Shoplifting is the most common crime facing retailers and it can be extremely costly.

There are systems and policies that you can implement that can reduce the amount of shoplifting or virtually eliminate it. Some of the solutions are more expensive; however, you should carefully consider all of your options, and choose based on a costs-benefit analysis.

Shoplifters come in all shapes and sizes. It is very difficult to profile a shoplifter. They can be young or old, amateur or professional. The reason for shoplifting may be real need, or it may be for the thrill. The best defence against any shoplifting is a good preventative system.

There are three areas where you should focus your energies for shoplifting prevention.

They are:

- **Train your employees:** having employees on the floor, engaged with customers, offering assistance, is an effective deterrence for shoplifting. Shoplifters are scared off easily by the presence of alert store personnel.
- **Layout:** good visibility through out the store is important. Avoid "blind" spots, which can be formed by high shelving or protruding aisles. Use mirrors or closed circuit television cameras if you cannot physically monitor the entire store.
- **Protective equipment:** installing special equipment may help deter shoplifting. While closed circuit television systems are highly effective, you may find them expensive. Two-way mirrors may be a good substitute.

3.5 Insurance cover

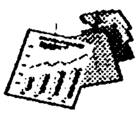
Insurance is used by businesses all over the world to help manage risks to business assets. Through insurance cover, you can pay a regular premium (fee) to an insurance company who will in-turn underwrite your risk should anything bad happen to your business. Typically, insurance companies will insure your business for several types of risks:

Type of Insurance	Benefit
Worker's Compensation	This insurance provides money in the case of a worker suffering job-related injury. If the worker is injured on the job, workers compensation insurance will pay that worker for medical expenses that are related to recovery from his illness.
Business Coverage: Property and equipment	Damage to business property caused by fire, smoke, flood, and water damage from storms, vandalism, and theft. This type of insurance can apply to property that your own, rent or lease. If your property is damaged from an eligible event, then the insurance company will pay you the value of your loss or the insured amount.
Third Party Compensation Coverage	An accident that causes injury to other people at your business, or an accident that causes damage to someone's property, can be covered by insurance. If some one suffers, an injury from a product you produce and sell or if personal injury is caused to someone through your business, the insurance company will cover the liability in the case of lawsuits from customers, employees and other parties.
Business interruption coverage	If your business suffers a loss in business due to an insured disaster, fire or storm because it takes time to make repairs and get your business up and running again, the insurance can pay you for the loss revenues.
Vehicle coverage	If a vehicle you own or lease is stolen or damaged or if the vehicle is involved in an accident that causes damage to property or injury, the insurance can pay for the costs related to those incidents.

Local legislation may require some of these insurance policies (e.g. Worker's Compensation) if you are an industrial business, which employs workers. It is important to be familiar with the Jordanian laws to insure that you are in compliance.

You may, also find that some of these types of insurance are very expensive, and that they will be unaffordable or the premium may be too high given the relative risk you face. For example, if you have a very old machine, it may not be worth insuring it, because the insurance company would charge you a high premium, but they would not pay you very much if the machine were damaged, and you made a claim.

Insurance companies will not insure all the risks you can possibly face in your business. Most insurance will not cover loss and damages due to war. However, the most common types of loss and damage your business can face can be covered, to some degree, by insurance.



CASE STUDY

Hana Juice Company (HAJCO) Ltd.

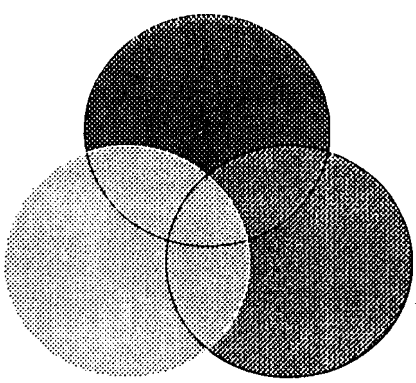
HAJCO Insurance coverage

In his review of risks, Mr. Jameel felt that his insurance broker had given him good advice, and that he was well covered against the normal business risks. When he contacted his insurance agent about the incident with the driver, the insurance specialist confirmed that insuring against the type of risk involving the delivery driver could indeed by prohibitively expensive. On the other hand, He told Mr. Jameel that if he changed the practice of having the drivers handle cash and implemented tight control over the inventories, the existing risks could be insured for premiums that are more reasonable. At the same time, the insurance broker reviewed the other policies with Mr. Jameel and reminded him that he had been too busy to take the time to ensure that the cover against fire etc is until sufficient given the expansions visible in the plant. As a result, Mr. Jameel agreed to take the time to review the recent additions and adjust the cover accordingly.

3.6 Family and business

Your family and your business are probably the two most important things in your life. They are mutually dependent on each other. What happens to one will most probably affect the other.

In most cases, the family supports you and your business; your business provides support for you and your family. However, sometimes, the family can exert a negative influence on the business. This can happen several ways.



Managing your family can be as difficult as managing your business. You need to strike a balance between the demands of your family and the demands of your business. If you favour the business too much, the relationship with your family may suffer, if you favour the family too much, your business may suffer.

The good news is there are some things you can do to minimise the problems that can exist between family and business.

■ Conflict over funds

It is surprisingly easy for family members to disagree over money. Sometimes, family members will feel that one member is unfairly treated and gaining too much money from the business. Other times a family member will feel they are underpaid and will be resentful. These kinds of problems can only fester like an open wound , as time goes on, they become more serious. It is better to have agreements up-front, so everyone understands the 'rules'.

Another place where conflict over funds arises is in the extended family. You may often feel pressure to help your brothers, sisters, uncles and cousins with money when you see they are struggling. However, if you help everyone out, you will find that there is not enough money in the business to finance your expansion plans. You need to devise a way to limit the amount of money you pay out to your extended family.

- **Pay yourself a salary:** a family emergency may require you to draw funds from the business. This withdrawal of funds may be more than the business can support, and may have a negative impact on the business.

You need to pay yourself a salary that allows you to live comfortably. At the end of the year, after you have objectively assessed the performance of the company, and projected your capital requirements for the future, you may consider paying yourself a bonus if the company has done well. Your salary and year-end bonus should be the only money you take out of the business.

- **Keep family and business finances separate**: you may mix personal and family finances with business finances. This can cause serious problems with business partners, tax authorities and others. Additionally, it can create considerable confusion with the business finances, and make your financial management and planning extremely difficult.

Important

Under no circumstances should family and business finances be mixed. The business should have separate bank accounts. Money should only move from the business to you in the form of a salary or annual bonus. If you transfer money into the business, it should be recorded as a formal loan or equity injection.

Conflict Over Family in and Around The Business

Problems can arise when family members work for the business, or are part of the ownership structure. If family members do not have clear roles in the business, confusion may result over authority and responsibilities. Additionally, employees may feel that family members are treated favourable at their expenses. This could lead to jealousy and impact employee moral.

- **Be careful when employing family**: if you hire a family member in the business, think carefully about your decision. Is this a business decision? What effect will it have on the business? Will I be able to treat this family member equally with other employees?

  Sometimes family members can be good employees. You may feel that you can trust your family more than an outsider. Your family member may bring commitment, skills and knowledge that your business needs. However, remember that it is not always easy for family members to work together in the same business. Do not employ family members just because they need a job. This will only cause you greater problems in the future.

- **Manage your extended family:** the extended family may feel entitled to share in the benefits of the business. They may request financial support, which is beyond the ability of the business to pay, or they may request employment from the business you may not want to employ them. The extended family can exert considerable social and emotional influence causing you to make poor business decisions.

Your extended family can place a large burden of responsibility on you. It is not possible to ignore your extended family. However, you can set a limit. In reality, there is a limit to how much you can help.

When you compute your salary, include an allowance for the extended family. This amount should be reasonable, but not so generous that it causes a strain on you and your family. The extended family allowance can be held in a separate bank account. When you receive a request for assistance from your extended family, you can pay them from the allowance instead of taking money from the business.

Do not be blackmailed into providing jobs for family members who cannot legitimately contribute to the productivity and growth of the firm. If you give in to pressure, you may end up with more problems than you solved.

Keep the following points in mind:

1. **Regarding Insurance:**
   - Consult a reputable insurance broker
   - Review all of your risks with him and ensure that you are adequately covered where it is cost-effective
   - Review regularly the level of coverage, as your business grows, so will the risks
2. **Regarding Family and Business**
   - Pay yourself a salary. Do not run to the till every time you need money.
   - Keep business and family money separate.
   - Set-up a special budget to save money for the family.
   - Establish a policy regarding hiring of family members. Stick to it!

CASE STUDY

Hana Juice Company (HAJCO) Ltd.

Refer to the HAJCO case study background in the Strategy Module.

- Does Mr. Jameel handle his family and business issues well? Why?
- What should Mr. Jameel do about his brother-in-law? Why?
- If Mr. Jameel does not hire his brother-in-law, what reaction can he expect from his family? Are there things he can do to improve the situation?

EXERCISE

The Relationship between You, Family and Business

1. Can you think of any examples where your family has had an impact on your business?
2. Was that impact positive or negative?
3. What actions could you have taken to improve the situation?

Action Plan

- Accounting Control and Fraud Prevention System
- Work with your accountant to develop internal controls for your company.
- Identify areas in your business where you are at particular risk for fraud or loss through poor procedures and negligence.
- Test your systems.
- When hiring new employees, screen them carefully and slowly add to their responsibilities as you gain confidence in them.

Burglary and Robbery

- Assess your business for and identify risks for Burglary and Robbery.
- Work with a reputable security firm to design solutions to the risks you identify and implement these solutions.

4. Chapter summary

- Every business has risks of loss. As a business grows, this risk becomes more so. It is important to assess your risks, develop systems to control risk and minimise potential losses.
- Your business represents a very significant financial investment. Any loss to your business through errors due to poor procedures, natural disaster, fire, embezzlement, fraud, theft or robbery affects you directly.
- Many businesses find that the greatest potential crime threat comes from their own employees. The **EYB: Strategic Human Resource Management Module** discusses ways to select, interview and hire new employees. By hiring quality people, you will avoid many problems and reduce the incidents of employee theft.

- Work with your accountant to establish internal control systems. If the company keeps good records and has good operating procedures, it will be easier to track assets, and discover if things are missing.
- **Embezzlement and Fraud:** is a very common form of employee theft. Learn to understand the various forms of embezzlement, fraud and how to prevent them.
- **Computer Crime:** Computers allow companies to perform common business operations quicker and much more efficiently than every before. However, computers also bring extra risks to a company. The computer you depend on to help run your business can be used against you to damage your business.
- **Burglary and Robbery**: can be a major source of loss for many businesses. As a business owner, you are seen as a good target for a robber, because you are successful, and you may have money. Your business is a target for the same reason. Understand the nature of your risks, and take precautions to minimise it.
- **Customers and People Posing as Customers**: can be a major source of loss through shoplifting, bad cheques, credit card fraud and money changing schemes. Lean to identify the common methods; and develop strategies to minimise your risk of loss.
- **Insurance coverage**: is an important tool for a business to use to help minimise loss due to natural disaster, fire, theft or vandalism. It is also, important to consider using insurance to cover the injury of your workers in case of liability. You should contact an insurance broker and fully investigate your insurance options.
- **Family and Business:** in most cases, the family supports you and your business, and your business provides support for you and your family. However, sometimes, the family can exert a negative influence on the business.
  - Keep family and business finances separate
  - Pay yourself a salary
  - Be careful when employing family
  - Set-aside money in a budget for extended family needs.

5. Make an action plan for safeguarding your business

Complete the form below to safeguard your business and prevent burglary and robbery. The action plan shown in the next page is useful when you prepare your financial growth plan, where you can have a master action plan for all aspects of your financial management.

You can find the forms for preparing your Action Plan in the Financial Management Growth Plan.

ACTION PLAN

OBJECTIVE (What to achieve?)	ACTIVITIES (What should be done?)	TIME FRAME (When it should be done?)		RESPONSIBILITY (Who should do it?)	RESOURCES (How it should be done?)	COMPLETED
		START	END			
						❑
						❑
						❑
						❑
						❑
						❑

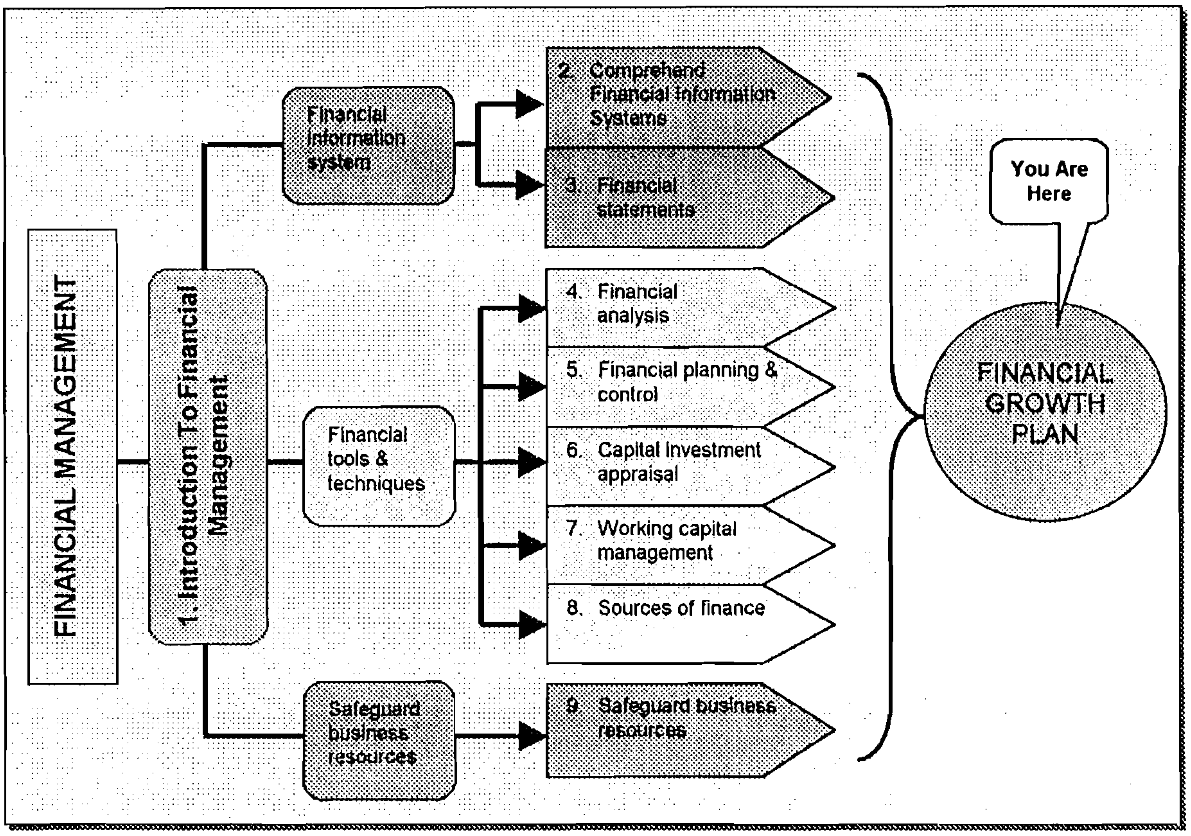
Chapter 10

FINANCIAL GROWTH PLAN

What you will learn in this chapter ...

After studying this chapter, and completing the exercises in it, and with the guidance of your business trainer, you should be able to:

- **Prepare your financial growth plan.**
- **Make an action plan for your financial management activities.**



1. What is a Financial Growth Plan

A financial management growth plan is a plan that assesses the firm's financial resources and financial needs, based on the overall business strategy, and then develops a specific plan to ensure that the business has the necessary financial resources to implement the decided growth strategy.

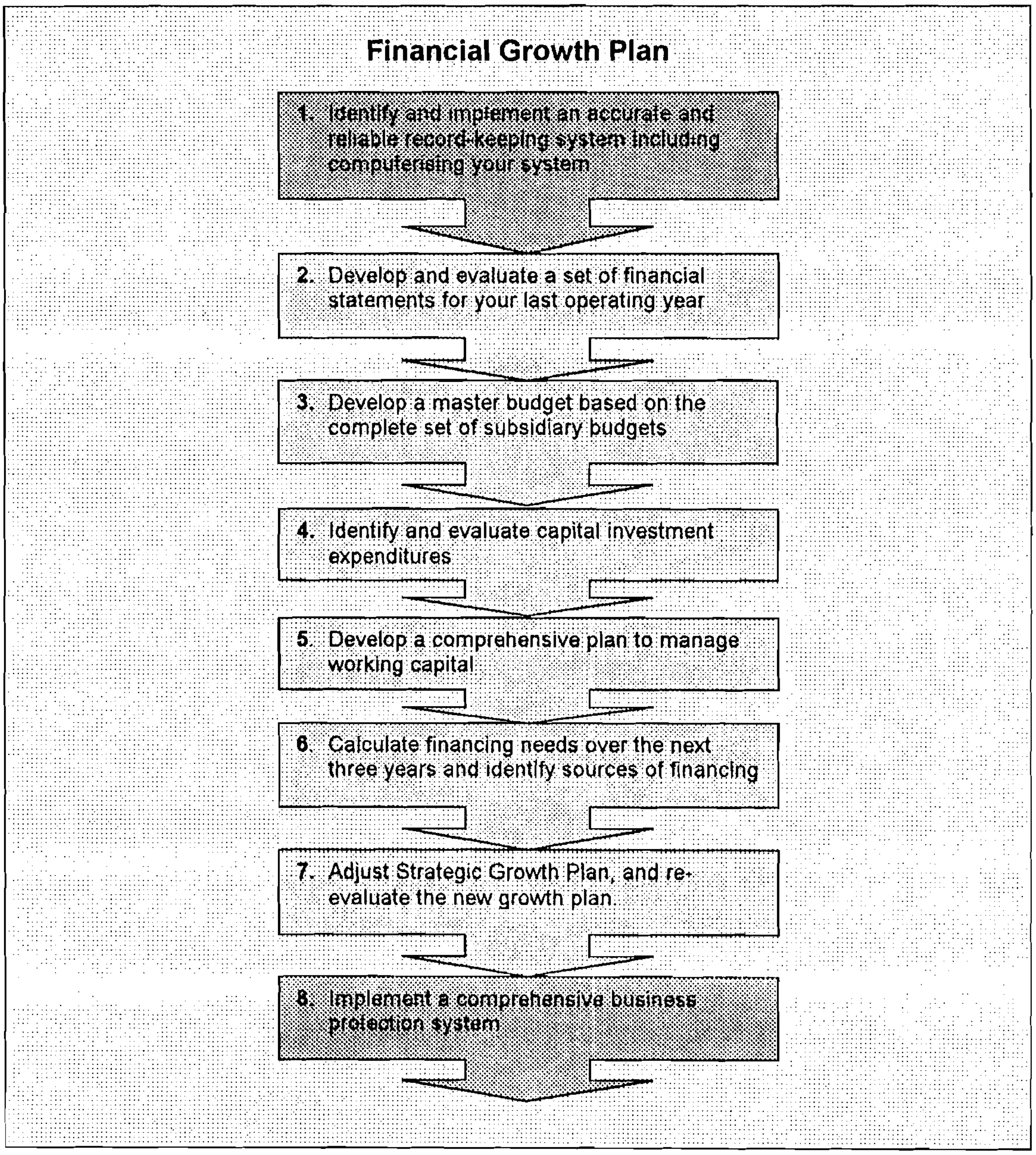
2. How does the financial growth plan help your business expand?

While it is critical to develop a strategy for growth, it is equally critical to ensure that the growth strategy is financed. As this point in the Financial Management Module you should see that there are many elements involved in business finance. Additionally, these elements must come together smoothly for the business to realise your growth ambitions. The financial growth plan maps out the various items of the financial management matrix, and ensures that business can "afford" its growth plan. Without a financial management growth plan, the business enterprise may set-off on an effective growth strategy, but falter due to lack of funds. A well-conceived financial management growth plan will help ensure that your growth plans have the best possible chance of succeeding.

3. How to design the financial growth plan

The financial growth plan is based on the strategic management plan. Once you have decided the basic strategy for your company, you will then need to decide how you will finance the implementation of that strategy. Additionally, you will also need to implement systems to track the financial progress of your business and safeguard your business assets. To achieve all of these important objectives, you will have to layout a specific financial growth plan.

The financial management growth plan should address the following areas:



3.1 Identify and implement an accurate and reliable record-keeping system including computerising your system

Ultimately, the entire purpose of financial management and financial planning is to provide quality financial information for making management decisions. However, if the financial information provided to management is incomplete, inaccurate or out-of-date, then poor decisions result. Management must be able to rely on the accuracy of the financial information provided. The first step in the financial growth plan is to ensure that the financial information used to evaluate the business and plan for business growth is reliable, accurate and timely.

If you are keeping your records by yourself, you need to hire an accountant to help you set-up a complete set of quality records. You may dislike the cost of an accountant, but it is extremely important to have the accountant to set up your record-keeping system correctly, so there will be no problems in the future. If possible, computerise the system, so that financial reports can quickly be produced.

3.2 Develop and evaluate a set of financial statements for your last operating year

Before you move forward, you have to know from where you are starting. It is important to develop a base-line set of financial statements including the Income Statement, Cash Flow Statement, and Balance Sheet. Your accountant should assist you with this step.

Refer to HAJCO's financial statements in Chapter 3.

Once the statements are developed, then you can analyse them by running the various financial ratios to determine profitability, efficiency, and liquidity, as outlined in Chapter 4.

Refer to HAJCO's financial analysis tools in Chapter 4.

This is an important step, because it provides information on the current financial health and capacity of the business. This information is used to determine the financial resources you will require to implement your strategic growth plan.

You will also be able to determine if you have any financial vulnerability, such as shortages of working capital, or slim profit margins that must be addressed in your strategic plan to ensure successful implementation of your growth strategy.

Your first step, therefore, is to have your accountant produce your financial statements, at least for the last two years, in similar format as used to demonstrate **HAJCO's** statements).

3.3 Develop a master budget based on the complete set of subsidiary budgets

Your Strategic Management Growth Plan is the map that your business will follow as you implement your growth strategies. In this plan, you will penetrate new markets, add new products and develop new ways to provide benefit to your customers.

Your Financial Management Growth Plan helps you to identify, and allocate resources that will be used to implement the Strategic Management Growth Plan. This process is the budget process. Fundamentally, the budget is the financial component of a Business Plan. It tells you where your revenues will come from, when they will come and how much they will be. It tells you the same information for operating expenses and capital expenditures.

The Financial Budget come from the Strategic Management Plan, and supports the Strategic Management Plan by planning the flow of financial resources that will fund the activities of the Strategic Plan.

Firstly, you need to make a broad view of your Strategic Plan in financial terms, focusing on the key pieces of information including your Income Statement, your investments in buildings, plant and equipment required for your business growth and your cash flow potential, to understand your probable financing requirements.

Refer to HAJCO's Financial Plan in Chapter 5.

Once done you have a good overall view of how feasible your long-term growth plans are, you will need to develop your annual budget from the first year of the Strategic Finance plan. This involves breaking down the Strategic Plan numbers into a level of detail, which allows you to plan exactly how you are going to achieve each line of the Income Statement. The individual items of capital expenditures necessary for the planned volume of business and strategic moves into new markets, products etc. and lastly, the cash flows to be generated and required for the preceding elements.

In the first place, do your budgeting at a level where you are comfortable. This should cover at least the summary level Income Statement, Inventory and Accounts receivable from the Balance Sheet (Chapter 7 explains the working Capital Management tools to help you here), the Capital expenditure budget and some idea of the cash flows and financing needs implicit in these documents.

3.4 Identify and evaluate capital equipment expenditures

Your Strategic Plan and Master Budget will certainly identify the need for specific capital equipment purchases, as described previously. Capital equipment purchases are typically large, long-term investments that are critical to the success of your business.

When making large financial investments, it is important to make sure that the limited resources are given maximum use. Each investment should provide an economic gain to the business that pays for the investment, and provides a profit for the business.

The projected return on the investment must be calculated in advance of committing funds to the project. This is important to be sure that the investments are profitable and worth pursuing. The tools we use for this are **PAYBACK PERIOD, NET PRESENT VALUE, INTERNAL RATE OF RETURN AND PROFITABILITY INDEX.** You can use the models described in Chapter 6, for assessing whether such investments will bring the required profitability to your company.

3.5 Develop Comprehensive Plan to Manage Working Capital

Chapter 7 describes in detail how to plan and manage the main elements of Working Capital.

Refer to HAJCO's working management tools in Chapter 7.

In the first place, you should focus on putting in place the processes described her for planning and managing Inventories and Accounts receivable. The examples for **HAJCO** were:

Ideally, this exercise should be done separately for:

- Raw materials,
- Work in Progress
- Finished goods,

As well as inventories, the major item in Working capital we considered was Accounts Receivable. We used two main tools in HAJCO, one for assessing whether a customer can be granted credit terms and the second, to track the customers who are late settling their accounts. The models we used, and which you too should use to control customers doing business on credit terms are discussed in Chapter 7.

3.6 Calculate Financing Needs Over the Next Three Years and Identify Sources of Financing

Once the Financial Growth Plans are developed, including projected balance sheet items (Cash, Accounts Receivable and Inventories), Income statements and Cash flow, it is then critical to go back and analyse these projected statements to be sure that minimum financial benchmarks will be met. Typical benchmarks that should be evaluated are profitability rations, liquidity ratios, turnover ratios and working capital ratios (Chapter 4 details what these ratios are and how they are calculated).

The goal here is to ensure that the financial plan that has been developed to support the strategic plan is financially sound, and provides an acceptable rate of return for the company. No matter how promising a financial growth plan may sound, if the numbers do not add up, then it is not worth pursuing. You will need to go back to adjust your plan to better fit the financial realities of the business.

If the plan then reveals that, at some stage in the planning window, you will need additional long-term financing, Chapter 7 gives you the tools to establish your Financing strategy, and tips on putting a sound strategy in place and implementing it.

The tools we used to help HAJCO were:

- Identifying the capital structure options and understanding their effect on your balance sheet.
- Understanding the advantages and disadvantages of Leverage and performing sensitivity analysis on your options to choose the right level of risk.

3.7 Adjust Strategic Growth Plan and Re-evaluate the Growth Plan.

In Chapter 5, you also looked at the need to compare regularly and timely the actual performance against the budget. The purpose of this is to diagnose all problems, as early as possible, and put in place the appropriate corrective action plans. In addition, if significant variances start to occur, it will be necessary using the same processes for the budget to re-forecast the probable results for the full year. This will help decide on the appropriate actions either to get back to plan or to limit the losses, or indeed, maximise upside potential.

This is how **HAJCO** structured this analysis and the plans put in place as a result.

You need to develop a similar process to measure your results, and plan the appropriate actions.

This whole cycle of':

Updating the long-range plan,
Preparing your budget, and
Tracking performance, re-forecasting if necessary
Making and executing corrective action plans

Will then be repeated annually for, as long as, your business exists!

It will become the driving and coordinating force of your planning and business management process.

3.8 Implement a Comprehensive Business Protection System

Lastly, you will need to look at your business practices and controls, including security. Chapter 9 covers this in detail and suggests the following checklist for you:

Accounting Control and Fraud Prevention System

- Work with your accountant to develop internal controls for your company.
- Identify areas in your business where you are at particular risk for fraud or loss through poor procedures and negligence.
- Test your systems.
- When hiring new employees, screen them carefully, and slowly add to their responsibilities as you gain confidence in them.

Burglary and Robbery

- Assess your business for and identify risks for Burglary and Robbery.
- Work with a reputable security firm to design solutions to the risks you identify and implement these solutions

Insurance

- Consult a reputable insurance broker
- Review all of your risks with him and ensure that you are adequately covered where it is cost-effective
- Review regularly the level of coverage, as your business grows, so will the risks

Family and Business

- Pay yourself a salary. Do not run to the till every time you need money.
- Keep business and family money separate.
- Set-up a special budget to save money for helping the family.
- Establish a policy regarding hiring of family members. Stick to it.

Company Name: ______________________________

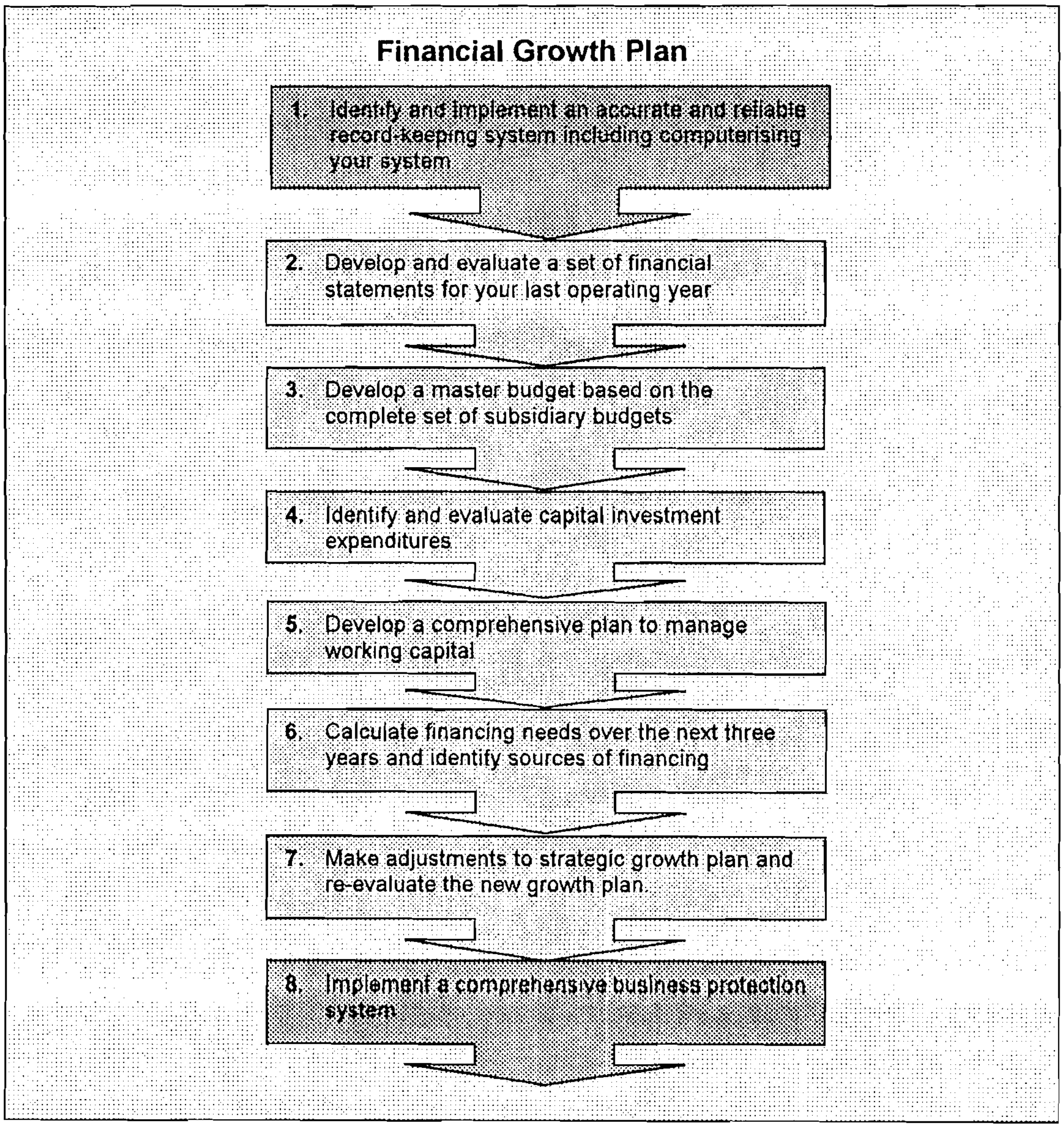
FINANCIAL MANAGEMENT GROWTH PLAN

FOR THE PERIOD

Month, 200_ to Month, 200_

4. Financial Growth Plan Forms

As stated in section 3 of Chapter 10, the Financial Growth Plan is based on the Strategic Management Plan. Once you have decided the basic strategy for your company, you will then need to decide how you will finance the implementation of that strategy. Additionally, you will also need to implement systems to track the financial progress of your business and safeguard your business assets. To achieve all of these important objectives, you will have to layout a specific financial management growth plan. The following flow chart illustrates the steps taken to develop a financial growth plan. Further, in this section, each step has a series of checklists and forms that must be completed in order to develop the financial growth plan.



Step One: Identify and implement an accurate reliable record-keeping system including computerising your system.

When you decide to move your accounting records to a computerised system, you should follow a systematic process. The following five steps will help you manage this transition. Identify who will be responsible for completing each step and by when. Set a "Check on the Progress" date and tick it off when the task is complete.

OBJECTIVE (What to achieve?)	ACTIVITIES (What should be done?)	TIME FRAME (When it should be done?)		RESPONSIBILITY (Who should do it?)	RESOURCES (How it should be done?)	COMPLETED
		START	END			
Recruit a paid, professional or expert to help you in the conversion process						❑
With the help of your accountant, you will need to simultaneously determine the management information needs.						❑
Identify and evaluate competing computerised financial management systems.						❑
Choose the system that best meets your needs, and financial resources available. The computerised system you finally choose should cost effectively meet the information needs of your business for several years to come.						❑
Implement the computerised financial management system, thoroughly testing it before stopping the manual processes.						❑

Step Two: Develop and evaluate a set of financial statements for your last operating year.

Before you move forward, you have to know from where you are starting. It is important to develop a base-line set of financial statements including the Income Statement, Cash Flow Statement and Balance Sheet. Your accountant should assist you with this step by completing the form shown in the next page. Once the statements are developed, then you can analyse them by running the various financial ratios to determine profitability, efficiency and liquidity, as outlined in Chapter 4.

	Item	2002	2003
[I]	Net Sales (Turnover)		
[II]	Less: Cost of Sales		
[III]	**Gross Profit**		
	Selling and Distribution Expenses		
	G&A Expenses		
	Salaries		
	Bad Debts		
[IV]	**Total Operating Expenses**		
[V]	**EBITDA**		
[VI]	Depreciation		
[VII]	Amortization		
[VIII]	**EBIT**		
[IX]	Interest Charges		
[X]	**EBT**		
[XI]	Corporate Tax @15%		
[XII]	**Net Income**		

	2002	2003
	J.D.000	J.D.000
Beginning Inventory		
Production cost:		
Raw material		
Factory wages		
Factory rent		
Electricity and water		
Depreciation, Machinery		
Total production costs		
Total available		
Less: Closing inventory		
Cost of Goods sold		
Distribution Costs		
Total cost of Sales		

[A]	Assets	2002	2003
[B]	**Current Assets:**		
[C]	Cash on hand and at banks		
[D]	Inventories		
[E]	Accounts Receivable		
[B]	**Total Current Assets**		
[F]	**Fixed Assets:**		
	Fixed Assets: At Cost		
	Less Accumulated Depreciation		
[F]	**Net Book Value of Fixed Assets**		
[G]	Other Assets		
[A]	TOTAL ASSETS		
[H]	**Liabilities and Shareholders Equity**		
[I]	**Current Liabilities**		
[J]	Accounts Payable		
[K]	Accrued Expenses		
[H]	**Total Current Liabilities**		
[L]	**Long Term Liabilities:**		
[L]	Long Term Loans		
[L]	**Total Long Term Liabilities**		
[M]	**Shareholders Equity:**		
[N]	Paid-up Capital		
[O]	General Reserves		
[P]	Retained Earnings		
[M]	**Total Shareholders' Equity**		
[H]	TOTAL LIABILITIES AND SHAREHOLDERS EQUITY		

Retained profits reconciliation

	2002 J.D.000	2003 J.D.000
Beginning retained profits		
Add: Profit for the year		
Less: Transfer to general reserve		
Less: Dividends to shareholders		
Ending retained profits		

	Item	2002	2003
[AA]	**Cash Flows From Operating Activities:**		
	Net Income		
	Plus: Depreciation		
	Change in Working Capital:		
	(+)/- Change in Inventories		
	(+)/- Change in Accounts Receivable		
	+/(-) Change in Accounts Payable		
	+/(-) Change in Accrued Expenses		
[AA]	**Net Cash Flows from Operating Activities**		
[BB]	**Cash Flows From Investing Activities**		
	Cash Inflows:		
	Sale of Assets		
	Total Cash Inflows		
	Cash Outflows		
	To Capital Investments		
	Total Cash Outflows		
[BB]	**Net Cash Flows from Investing Activities**		
[CC]	**Free Cash Flow**		
[DD]	**Cash Flows From Financing Activities:**		
	Cash Inflows		
	From Loans		
	Total Cash Inflows		
	Cash Outflows		
	To Loans (Prepayment)		
	Total Cash Outflows		
[DD]	**Net Cash Flows from Financing Activities**		
[EE]	**Net Cash Flows for the Period**		
[FF]	Cash Opening Balance		
[GG]	**Cash Closing Balance**		

Step Two- Part 2: Financial Analysis Forms

1) Comparative Financial Statements

Use the previous financial statement forms to conduct the Comparative Financial Statements Analyses:

- **Horizontal Analysis (Trend Analysis)**
- **Vertical Analysis (Common Size Analysis)**

II) Ratio Analysis

Utilize the exercises you solved during the course to analyse your financial statements to prepare your financial plan and set your **SMART** objectives for your financial management function.

Item	Unit	Equation	2002	2003	Benchmark Value	Comments (what I will do to improve the ratio)
Profitability Ratios						
Gross Profit Margin	%					
Operating Profit Margin	%					
Net Profit Margin	%					
Return on Investments (ROI)	%					
Return on Equity (ROE)	%					
Liquidity Ratios						
Current Ratio	Times					
Quick Ratio	Times					
Working capital	J.D 000					
Leverage Ratios						
Leverage Ratio	%					
Debt to Equity Ratio	%					
Activity Ratios						
Total Assets Turnover	Times					
Fixed Assets Turnover	Times					
Current Assets Turnover	Times					
Working Capital Management						
Inventory Turns	Times					
Days Sale Outstanding (DSO)	Days					

Step Three: Develop your budget for the next 3 years

Your Financial Management Growth Plan helps you identify, and allocate resources that will be used to implement the Strategic Management Growth Plan. This process is the budget process. Fundamentally, the budget is the financial component of a business plan. It tells you where your revenues will come from, when they will come and how much they will be. It tells you the same information for operating expenses and capital expenditures.

Firstly, you need to make a broad view of your Strategic Plan in financial terms, focusing on the key pieces of information including your Income Statement, your investments in buildings, plant and equipment required for your business growth and your cash flow potential, to understand your probable financing requirements.

The following forms can be used as tools.

Item	2003	2004	2005	2006
Net Sales (Turnover)				
Less: Cost of Sales				
Gross Profit				
Selling and Distribution Expenses				
G&A Expenses				
Salaries				
Bad Debts				
Total Operating Expenses				
EBITDA				
Depreciation				
Amortization				
EBIT				
Interest Charges				
EBT				
Corporate Tax @15%				
Net Income				

Assets	2003	2004	2005	2006
Current Assets:				
Cash on hand and at banks				
Inventories				
Accounts Receivable				
Total Current Assets				
Fixed Assets:				
Fixed Assets: At Cost				
Less Accumulated Depreciation				
Net Book Value of Fixed Assets				
Other Assets				
TOTAL ASSETS				
Liabilities and Shareholders Equity				
Current Liabilities				
Accounts Payable				
Accrued Expenses				
Total Current Liabilities				

Long Term Liabilities:				
Long Term Loans				
Total Long Term Liabilities				
Shareholders Equity:				
Paid-up Capital				
General Reserves				
Retained Earnings				
Total Shareholders' Equity				
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY				

Once this is done, and you have a good overall view of how feasible your long-term growth plans are, you need to develop a capital budget. Capital expenditures are usually the largest investment for any enterprise and must be carefully planned. Work through the strategic plan, and develop a list of capital expenditures, which will occur in this planning year.

Step Three- Part 2: Analyse your Projected Financial Statements

I) Comparative Financial Statements

Use the previous financial statement forms to conduct the Comparative Financial Statements Analyses:

- **Horizontal Analysis (Trend Analysis)**
- **Vertical Analysis (Common Size Analysis)**

II) Ratio Analysis

Item	Unit	Equation	2004	2005	2006	Target Value	Comments (what I will do to achieve target value)
Profitability Ratios							
Gross Profit Margin	%						
Operating Profit Margin	%						
Net Profit Margin	%						
Return on Investments (ROI)	%						
Return on Equity (ROE)	%						
Liquidity Ratios							
Current Ratio	Times						
Quick Ratio	Times						
Working capital	J.D.000						

Leverage Ratios							
Leverage Ratio	%						
Debt to Equity Ratio	%						
Activity Ratios							
Total Assets Turnover	Times						
Fixed Assets Turnover	Times						
Current Assets Turnover	Times						
Working Capital Management							
Inventory Turns	Times						
Days Sale Outstanding (DSO)	Days						

Step Four: Identify and Evaluate Capital Equipment Investments.

Based on your operating budgets, identify all of your capital investments. Utilising Payback Period Analysis and Net Present Value Analysis, evaluate the different investment options you are faced with, and ensure that they are good financial investments for your company.

Calculate Pay Back Periods: using the following form

Year	Option- I (J.D.)		Option –II (J.D.)	
Cost	(__________)		(__________)	
	Annual	Accumulated	Annual	Accumulated
Cash flow year 1				
2				
3				
4				
5				
6				
7				
Payback period				

Calculate NPV, PI and IRR, using the following form

Year of Cash Flow	Gross Cash Flow (J.D.)	Discount factor	NPV of Cash flow (J.D.)
Zero (Investment)	(______)	1.00	(______)
One	______	______	______
Two	______	______	______
Three	______	______	______
Four	______	______	______
Five	______	______	______
Six	______	______	______

Total NPV of project (NPV) ________J.D.

Profitability Index of the Project (PI) ________J.D.

Internal Rate of Return (IRR) ________%

Step Five: Develop a comprehensive plan to manage working capital.

You need to first analyse your working capital requirements. Then develop a set of credit and collection policies for your business. Analyse your debtor accounts, and develop a plan to improve collections. Finally, analyse your inventory requirement, and develop an Inventory Management Plan.

Working Capital Sheet: use the following form

Assets	2003	2004	2005	2006
Current Assets:				
Cash on hand and at banks				
Inventories				
Accounts Receivable				
Total Current Assets				
Current Liabilities:				
Accounts Payable				
Accrued Expenses				
Total Current Liabilities				
Working capital				

Credit Management and Collection Policies

The next step is to develop a credit management and collection policy for your company. This is a critical step in your overall working capital management plan.
Below are the steps you must take:

1. Determining credit policy	Which includes: a) Setting the credit standard b) Evaluation of potential, and selection of credit customers c) Deciding on specific credit terms for each customer
2. Collection policy	Which includes 1. Ensuring compliance with credit terms 2. Ensuring timely invoicing to customers 3. Control and analysis of accounts receivable (debtors) 4. Defining procedure to be followed on defaulting debtors

Inventory Management

By now, you know that inventory can tie up precious working capital in unproductive uses. On a quarterly basis, determine your required inventory holding and your inventory turnover period. It is important to monitor these areas closely, to avoid costly losses due to excessive inventory.

Required inventory holding (Give a target Inventory turnover period)	**Inventory turnover period** (To evaluate whether the business is operating in accordance with its policy with respect to its target inventory turnover period)
Average Inventory Holding = Target inventory turnover period $\times \frac{\text{Cost of sales}}{365}$	Inventory Turnover Period = $\frac{\text{Average inventory}}{\text{Cost of Sales}} \times \frac{365}{1}$

Analysis Check List

Look at your most recent balance sheet and the Ratio analysis you did in chapter 2; review these various aspects of your business. If any one area looks wrong, conduct an investigation, and determine what is causing the problem. Be pro-active and take corrective action immediately.

- ❑ Are you satisfied with the level of your inventory turns?
- ❑ Are you Customer Accounts receivable under control?
- ❑ Is your Days Sales Outstanding ratio reasonable compared to your sales terms?

Inventories

- **Raw materials**
  - ❑ Is your level of Raw material inventory sufficient to keep production running smoothly, but not so high that you have losses through theft, deterioration or obsolescence?
- **Work in Progress**
  - ❑ Is your production cycle time optimised and under control, or do you have excessive amounts of material in a semi-finished state?
- **Finished goods**
  - ❑ Is the level so low at times, that it interrupts deliveries to customers, or so high that you have the problems mentioned above of theft, deterioration or obsolescence?
- **Total inventory**
  - ❑ Does your inventory and production planning ensure that you have the right quantities to keep the business flowing, but without unnecessarily tying up funds, you could use better elsewhere?

Accounts receivable (Debtors)

- ☐ Do you sell on credit?
- ☐ If so, do you have Credit approval procedures similar to those described above?
- ☐ Do you review regularly the overdue balances and have a defined follow-up process to avoid losses through bad debts?

Other working Capital items

- ☐ Do you negotiate the best payment terms with your suppliers or do you pay faster than you collect?
- ☐ Are there other Working Capital items tying up your valuable funds?

Step Six: Calculate Financing Needs Over Next Three Years and identify sources of financing.

Based on your Strategic Plans and Operating Budgets, calculate your financing needs over the next three years. Ensure that your business can afford the Strategic Growth Plan you have mapped out for it. If cash shortages will occur, identify sources of financing and secure that financing well in advance of when you will need it.

Go back to the income and balance sheet budgets and the capital expenditure budget. Develop the cash flow budget checking to make sure the business will maintain positive cash flow throughout the budget cycle, use the following forms.

Item	2003	2004	2005	2006
Cash Flows From Operating Activities				
Net Income				
Plus Depreciation				
Change in Working Capital:				
(+)/- Change in Inventories				
(+)/- Change in Accounts Receivable				
+/(-) Change in Accounts Payable				
+/(-) Change in Accrued Expenses				
Net Cash Flows from Operating Activities				
Cash Flows From Investing Activities				
Cash Inflows:				
Sale of Assets				
Total Cash Inflows				
Cash Outflows				
To Capital Investments				
Total Cash Outflows				
Net Cash Flows from Investing Activities				
Free Cash Flow				

Identify Sources of Financing

Assets	2003	2004	2005	2006
Long Term Debt:				
Long Term Loans				
Total Long Term Debt				
Shareholders Equity:				
Paid-up Capital				
General Reserves				
Retained Earnings				
Total Shareholders' Equity				
Capital Employed				

Prepare Cash Flow from Financing

Item	2003	2004	2005	2006
Free Cash Flow (from previous table)				
Cash Flows From Financing Activities				
Cash Inflows				
From Loans				
Total Cash Inflows				
Cash Outflows				
To Loans (Prepayment)				
Total Cash Outflows				
Net Cash Flows from Financing Activities				
Net Cash Flows for the Period				
Cash Opening Balance				
Cash Closing Balance (Cumulative Cash Flow)				

Step Seven: Adjust strategic growth plan and re-evaluate the new growth plan.

Compare regularly and timely the actual performance against the budget. The purpose of this is to diagnose all problems as early as possible, and put in place the appropriate corrective action plans. In addition, if significant variances start to occur, it will be necessary, using the same processes for the budget, to re-forecast the probable results for the full year. This will help decide on the appropriate actions either to get back to plan or to limit the losses, or indeed, maximize upside potential.

After your budgets are developed, use the following form to track the progress of your business as you implement your financial growth plan. This form helps you to spot variances in your financial performance early in the implementation phase. Once you find a variance, discover what is causing the variance, and if necessary, take corrective action.

Budget Variance Report					
Your company comparison of Year results with budget					
	Actual	**Budget**	**Variance(+ve/(-ve)**		**Comments/Proposed action**
			J.D.	**%**	
Operating budget					
Net Sales					
Cost of sales					
Gross margin					
% Sales					
Operating expenses					
Interest					
Tax					
Net profit					
% Sales					
Capital budget					
Fixed Assets					
Cash flow					
Cash from Operations					
Cash from Investment					
Cash from Financing					
Net cash flow					

Step Eight: Implement a comprehensive business protection system

You will need to look at your business practices and controls, including security. Also, evaluate the impact your family has on your business. Develop a schedule, and implement the necessary changes needed to insure your business is adequately protected, use the following form.

OBJECTIVE (What to achieve?)	ACTIVITIES (What should be done?)	TIME FRAME (When it should be done?) START	END	RESPONSIBILITY (Who should do it?)	RESOURCES (How it should be done?)	COMPLETED
Accounting Control and Fraud Prevention System						
Work with your accountant to develop internal controls for your company.						❑
Identify areas in your business where you are at particular risk for fraud or loss through poor procedures and negligence. Take corrective action.						❑
When hiring new employees, screen them carefully and slowly add to their responsibilities as you gain confidence in them.						❑
Test your systems.						❑
Burglary and Robbery						
Assess your business for and identify risks for Burglary and Robbery.						❑
Work with a reputable security firm to design solutions to the risks you identify and implement these solutions.						❑
Insurance						
Consult a reputable insurance broker.						❑
Review all of your risks with him, and ensure that you are adequately covered where it is cost-effective.						❑
Review regularly the level of coverage, as your business grows, so will the risks.						❑
Family and Business						
Pay yourself a salary. Do not run to the till every time you need money.						❑
Keep business and family money separate.						❑
Set-up a special budget to save money for helping the family.						❑
Establish a policy regarding hiring of family members. Stick to it.						❑

MY ACTION PLAN

Objective (What (To Achieve?)	Activities (What Should Be Done?)	Time Frame (When It Should Be Done?)		Responsibility (Who Should Do It?)	Resources (How It Should Be Done?)	Status
		Start	End			

MY ACTION PLAN

Objective (What To Achieve?)	Activities (What Should Be Done?)	Time Frame (When It Should Be Done?)		Responsibility (Who Should Do It?)	Resources (How It Should Be Done?)	Status
		Start	End			

Annex 1

GLOSSARY OF MANAGEMENT TERMS USED IN THIS MANUAL

Term	Its Meaning
Balance sheet	Is the financial statement that shows the financial position of the company at a given moment In time.
Cash flow statement	Is the financial statement that shows movement of cash inflows and cash outflows of the company in a specific period.
Comparative financial statements method	Is an easy and straightforward method of making comparisons. The distinct disadvantage however, is that the amount of the useful information that can be obtained from the comparative statements is limited.
Financial control	Refers to how the business ensures that its performance is in line with its plan.
Financial management	Is the business management function that monitors, controls, and allocates the vital resources of a business. It plays a key role in the formation of the primary business strategies and the achievement of key business objectives.
Financial planning	Involves quantifying in financial terms, the way in which the business intends to achieve its objectives.
Financial statements	Are summaries of the transactions of a business presented in a structured manner to give information concerning the business.
Income statement	Is the financial statement that shows revenues and expenses of the company to measure its profit and loss performance for a specific period of time.
Net working capital	Refers to the net of current assets (including inventory, accounts receivable and cash) and current liabilities (including accounts payable, accruals and bank overdrafts).

Term	Its Meaning

Annex 2

LIST OF REFERENCES

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Annex 3

ANSWERS TO EXERCISES

Trend Analysis Exercises:

Item		2002	2003
Net Sales (Turnover)		32%	30%
Less: Cost of Sales		38%	29%
Gross Profit Margin		**28%**	**31%**
Selling and Distribution Expenses		14%	25%
G&A Expenses		10%	9%
Salaries		6%	20%
Bad Debts		20%	67%
Total Operating Expenses		**10%**	**24%**
EBITDA		**45%**	**36%**
Depreciation		118%	13%
Amortization			
EBIT			
Interest Charges		114%	-20%
EBT		**19%**	**60%**
Corporate Tax @15%		19%	60%
Net Income		**19%**	**60%**

Assets		2002	2003
Current Assets:			
Cash on hand and at banks		-33%	71%
Inventories		6%	6%
Accounts Receivable		35%	26%
Total Current Assets		**0%**	**18%**
Fixed Assets:			
Fixed Assets: At Cost		22%	13%
Less Accumulated Depreciation		122%	62%
Net Book Value of Fixed Assets		**14%**	**5%**
Other Assets			
TOTAL ASSETS		6%	12%

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Liabilities and Shareholders Equity			
Current Liabilities			
Accounts Payable		-5%	-5%
Accrued Expenses		-17%	-20%
Total Current Liabilities		-7%	-8%
Long Term Liabilities:			
Long Term Loans		-10%	-13%
Total Long Term Liabilities		-10%	-13%
Shareholders Equity:			
Paid-up Capital		0%	0%
General Reserves		0%	0%
Retained Earnings		119%	87%
Total Shareholders' Equity		27%	34%
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY		6%	12%

Common Size Analysis Exercises:

Item		2002	2003
Net Sales (Turnover)		100%	100%
Less: Cost of Sales		48%	48%
Gross Profit Margin		52%	52%
Selling and Distribution Expenses		5%	5%
G&A Expenses		4%	3%
Salaries		11%	10%
Bad Debts		2%	2%
Total Operating Expenses		22%	21%
EBITDA		30%	31%
Depreciation		7%	6%
Amortization		0%	0%
EBIT		23%	25%
Interest Charges		5%	3%
EBT		18%	22%
Corporate Tax @15%		3%	3%
Net Income		15%	19%

Assets		2002	2003
Current Assets:			
Cash on hand and at banks		8%	12%
Inventories		36%	35%
Accounts Receivable		6%	7%
Total Current Assets		50%	53%
Fixed Assets:			
Fixed Assets: At Cost		58%	59%
Less Accumulated Depreciation		8%	12%
Net Book Value of Fixed Assets		50%	47%
Other Assets		0%	0%
TOTAL ASSETS		100%	100%
Liabilities and Shareholders Equity			
Current Liabilities			
Accounts Payable		26%	22%
Accrued Expenses		5%	4%
Total Current Liabilities		32%	26%
Long Term Liabilities:			
Long Term Loans		19%	15%
Total Long Term Liabilities		19%	15%
Shareholders Equity:			
Paid-up Capital		21%	19%
General Reserves		9%	8%
Retained Earnings		19%	32%
Total Shareholders' Equity		49%	59%
TOTAL LIABILITIES AND SHAREHOLDERS EQUITY		100%	100%

Profitability Ratios Analysis Exercise:

Item	Unit	Equation	2001	2002	2003
Profitability Ratios					
Gross Profit Margin	%	From Manual	53.6%	51.6%	52.0%
Operating Profit Margin	%	From Manual	23.2%	23.0%	25.3%
Net Profit Margin	%	From Manual	17.2%	15.5%	19.0%
Return on Investments (ROI)	%	From Manual	9.3%	10.4%	14.9%
Return on Equity (ROE)	%	From Manual	22.6%	21.2%	25.3%

Liquidity Ratios Analysis Exercise:

Item	Unit	Equation	2001	2002	2003
Liquidity Ratios					
Current Ratio	Times	From Manual	1.48	1.58	2.03
Quick Ratio	Times	From Manual	0.47	0.43	0.71
Working capital	000US$	From Manual	75.64	86.07	140.38

Gearing Ratios Analysis Exercise:

Item	Unit	Equation	2001	2002	2003
Gearing Ratios					
Gearing Ratio	%	From Manual	58.9%	50.9%	41.1%
Debt to Equity Ratio	%	From Manual	143.3%	103.6%	69.9%

Activity Ratios Analysis Exercise:

Item	Unit	Equation	2001	2002	2003
Activity Ratios					
Total Assets Turnover	Times	From Manual	0.29	0.35	0.41
Fixed Assets Turnover	Times	From Manual	0.62	0.69	0.87
Current Assets Turnover	Times	From Manual	0.54	0.69	0.77

Working Capital Management Ratios Analysis Exercise:

Item	Unit	Equation	2000	2001	2002
Working Capital Management					
Inventory Turns	Times	From Manual	0.69	0.89	1.09
Days Sale Outstanding (DSO)	Days	From Manual	30.80	31.39	30.42

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