

FINANCIAL MANAGEMENT

Introduction

Financial management is about measuring the right things; not too few, otherwise control may be lost, not too many otherwise resources will be wasted, and not the wrong ones otherwise critical business issues may be overlooked.

Many of the text books and training providers cover a wide range of measures in order to provide completeness, and in so doing fail to provide selectivity – so the temptation is to measure more, rather than less. This note is an opening attempt to identify the most appropriate business elements to measure and monitor for different businesses at different points in their growth and evolution.

Summary

Much of financial management tends to cover the entire spectrum of measures and ratios, leaving to the individual to work out which measures and ratios are the most useful for their particular company. Because companies are very diverse in their offerings, strategy and stage in organisational growth the choice of measures can be difficult to decide and there is the risk of measuring things that are inappropriate or of measuring things that don't need to be measured – risking either reduced control or wasted resources – both of which can significantly impact profitability.

The notes below consider the various financial measures and attempts to put them into the context of the organisation; whilst there may be some discussion about the aspects measured (e.g. whether to use Turnover or Gross Profit as a baseline) the key principle to remember is that of consistency – provided the same measures and datum points are used consistently, the measure will provide reliable information on which to base decisions.

The financial measures identified from an operational standpoint are divided into two blocks:

- The majority of organisations
- Organisations at different points in their development (some of the measures will carry through as the organisation develops)

| The majority of organisations | | As determined by growth stage | |
|-------------------------------|--|-------------------------------|---|
| Changes in turnover | | <i>Inventive</i> | |
| Gross margin | | | Development cost recovery |
| Gross profit | | | Interest as a proportion of borrowings |
| Wages costs and trends | | | Proportion of turnover from Intellectual Protection |
| Drawings, pensions etc | | <i>Innovative</i> | |
| Administration | | | Growth in net worth |
| Net Profit | | | Debt repayment |
| Net margin | | | Movement in stock value |
| Debtor days | | <i>Asset Driven</i> | |
| Creditor days | | | Return on assets |
| Working capital | | | Overhead as a percentage of turnover |
| Capital cover | | | Stock turn (days of stock) |
| | | <i>Brandstrength driven</i> | |
| | | | Cost per new customer |
| | | | Brand support and development |
| | | | Outlet success |

Setting the scene

As a business develops it goes through a number of transformations: Inventive, Innovative, Asset Driven and finally Brandstrength Driven. A company can pass through these stages, some not reaching the final stage but being content to stay at some point along the journey. The financial management criteria will change as the business changes; but first let's look at how a business could evolve

An example might be the mobile phone:

- Twenty five years ago it was very basic, and looked like a brick attached to a car battery with a whip aerial. It wasn't very reliable, there was only one model and it was expensive – the toy of the pop star. An inventive strategy, creating something that hadn't been there before
- Fifteen to twenty years ago all manner of shapes, sizes, colours and networks appeared – all smaller and easier to use than the original; each variant with a brief life, entering and leaving the market in very short time as both technical and cosmetic improvements were introduced. An innovative strategy, responding rapidly to (perceived) customer demand
- Ten to fifteen years ago two to three designs emerged as pre-eminent – lozenge shaped phones with a stubby aerial that fitted in a top pocket, had rubber buttons and with a standardised manufacturing process. Parts could be produced by anyone with the right equipment and a technical specification, sub-assembly managed from a limited number of sites around the world and taken to market through third party distribution. An Asset Driven strategy where specialisation ensures the minimum amount of production cost is included in each finished product
- More recently, one or two dominant suppliers have emerged, both as providers and as distributors where the cause to buy is more driven by the perception of the company than by the technological specification. A brandstrength Driven organisation using the strength and emotional content of their name to maintain and gain market share, either directly or through a franchise or licensed type of operation

Companies that have stopped along the way include:

- Inventive – Sinclair research
- Innovative – Intel
- Asset Driven – Mars
- Brandstrength Driven – McDonalds

Each with different demands by, and on, it's various stakeholders

The point at which growth stops seems to depend heavily on the CEO or founder, so when the leadership changes there can be a profound impact on the sustainability of the organisation which, for the investor, is the continued dividend return.

In a large organisation all the elements described above will be present: Invention in R&D, Innovative with sales and marketing, Asset Driven in production and Brandstrength Driven in growth and PR. It is quite normal for a large or diverse organisation to have separate departmental accounts because the various financial requirements differ from department to department e.g. Production will control costs, wastage and re-work, marketing will control relative/competitive pricing; and to put them together could be quite misleading

The above scenario directs thinking towards identifying which are the important financial elements to control, once the nature of a business, or its various departments and providers, has been established. As noted above, measuring too little risks loss of control, measuring too much risks wasted resources.

Some of the things to consider in deciding the right measures

Much of the financial teaching is based on large companies where the reporting is complete, which is good for teaching and highlights certain control points. However, the majority of UK companies are small, often with incomplete (or late) financial reporting and with different control points due to the immediacy of the market or the fragility of the product.

Some aspects will be needed to be managed whatever the business (Rappaport – Exhibit 1). The choice of 'variable' aspects to manage will depend on the type of business, or the particular department within the business (Exhibit 2)

Additionally, the strategic focus of the organisation can differ depending on how the business is being managed and to what end, this is summarised in Exhibit 3

In order to put the above into a context, the growth of an organisation is summarised at exhibit 4, using a music band as the evolving operation and how it might be developed by the record company (its management) – treating the two elements as a single organisation. It will be seen that the needs change as the organisation changes and grows in its marketplace.

All companies need to keep abreast of their overall financial standing, where the Profit & Loss (P&L) statement and Balance Sheet provide the statutory detail and Cashflow provides the management detail. Trend analysis provides planning detail and budget variance provides the operational detail. A summary of the key reports from P&L and Balance Sheet is at exhibit 5

Trend analysis is necessary to follow events and determine whether or not to take action (the action taken will depend on the type of company, its growth phase and strategic intent). Any of the entries in the P&L, Balance Sheet etc. can be monitored, often with a Moving Monthly Average (MMA) or Moving Annual Average (MAA); the advantages of such measures is that annual fluctuations such as seasonality are removed, the disadvantage is that response time can be slow; so, again the trends to monitor should be selected appropriate to the organisation's specific profile.

It should also be remembered that the various ratios and measures vary depending on the industry sector; for example, a manufacturer will have a relatively low Gross Margin as there will be significant purchases of materials to process; a legal firm will have a very high Gross Margin as their business does not demand the use of much in the way of materials.

Selecting the right things to measure

There are some sweeping assumptions in the notes below so any practical decisions should be properly considered, as should alternatives and options specific to an industry or to a parent (holding company, government etc.)

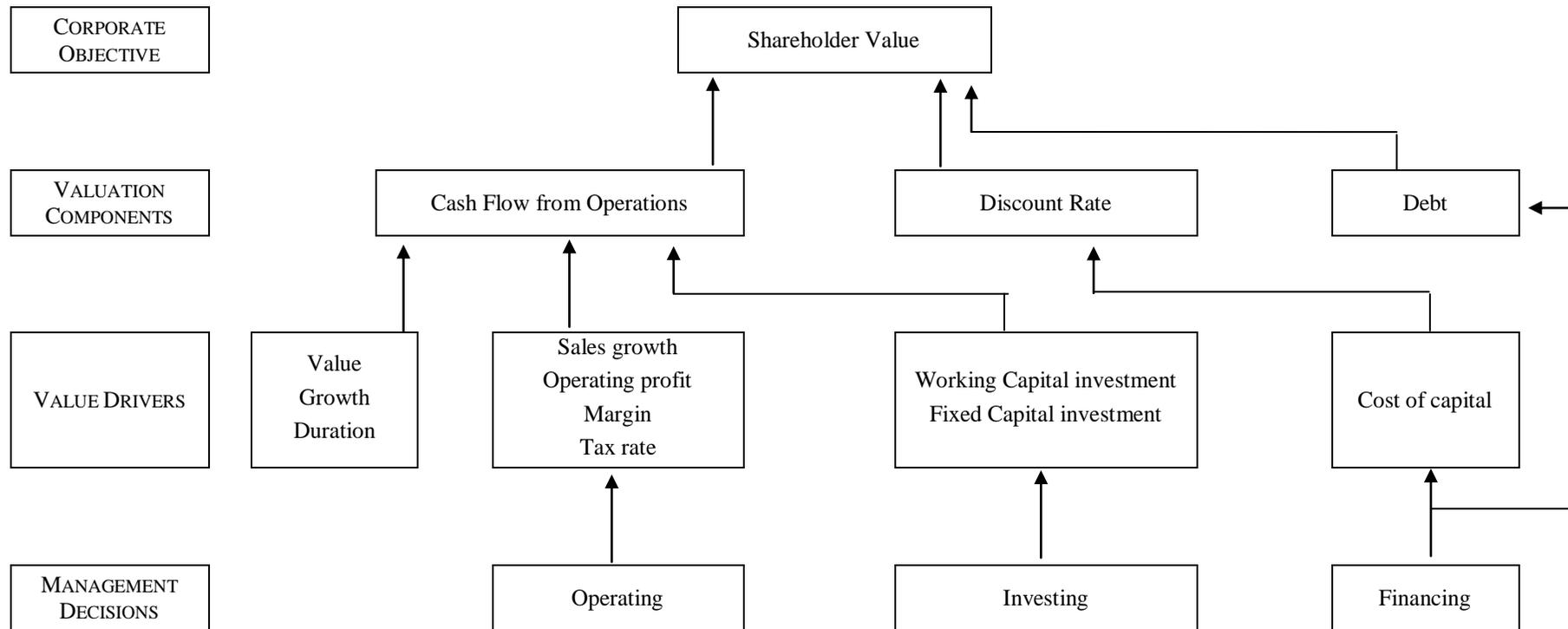
Some of the more important measures – all companies:

| What to measure | How it is derived – calculations at exhibit 6 | What it tells you |
|------------------------|--|--|
| Changes to turnover | MMA compared to the market | Growth in absolute terms |
| Gross Margin | Variable costs as a proportion of income | Are suppliers being properly managed, whether to seek alternatives |
| Gross Profit | Money left over after paying suppliers and materials | Can the fixed overheads be properly funded e.g. wages |
| Wages costs | Wages as a proportion of Gross Profit | Whether people are pulling their weight – also good to follow trends |
| Drawings | Drawings as a proportion of Gross Profit | Are the owners investing in themselves rather than the business |
| Administration | Administration as a percentage of Gross Profit | Whether effort and costs are being used productively |
| Net Profit | What is left over after all costs are met | The absolute profitability of the organisation |
| Net Margin | Net profit as a percentage of income | Whether the business is capable of supporting itself and funding growth |
| Debtor days | Trade debtors as a proportion of turnover | How long it takes to get paid |
| Creditor days | Trade creditors as a proportion of Gross Profit | How long it takes to pay suppliers |
| Working capital | Funds available to run the operations | A measure of the solvency of the business – ability to trade and operate |
| Capital Cover | A measure of how robust the business is | Length of time trading can continue with no income |

Some additional important measures – for specific types of company:

| <i>Inventive company</i> | | |
|--|--|---|
| What to measure | How it is derived – calculations at exhibit 6 | What it tells you |
| Development cost recovery | Selling price compared to market price | How competitive/desirable is the product or service |
| Interest repayment | Interest as a proportion of borrowings | Is the company over-reaching itself (inventive companies very loan dependent) |
| Development success | Income from (IP) as a proportion of turnover | How sustainable is the idea, product or company |
| | | |
| <i>Innovative company</i> | | |
| Product life in use | Turnover trend by product line | Which products to delete and which to concentrate on |
| Debt repayment | Interest and capital repayments as percentage Gross Margin | Whether the company can afford to invest in further development |
| Gross Margin by line | Percentage remaining after paying variable costs | Which product lines or services to develop/promote/delete |
| | | |
| <i>Asset Driven company</i> | | |
| Asset utilisation | Selling price compared to market price | How competitive is the product or service |
| Worth of the investment | Return on Net Assets (RONA) Return On Total Assets (ROTA) | Whether the money could be better invested elsewhere |
| Stock turn | Value of stock as a proportion of Gross Margin expressed in days | How well connected and efficient are sales and production |
| | | |
| <i>Brandstrength driven company</i> | | |
| Cost per new customer | Marketing cost divided by total number of units sold | The attractiveness of the brand |
| Brand support | Total marketing expenditure as a proportion of total turnover | The level of support being given to brand building |
| Outlet control | Turnover per outlet - ranked | Which outlets to use as models to develop business and which to support |

Exhibit 1 – Rapport – Measures for all businesses



Rappaport's shareholder value model (1998)

Measures appropriate to all businesses (some more important than others – depending on the type of business, where it is in its evolution and the temperament of the CEO/founder)

Exhibit 2- Measures by type of business

| | Inventive | Innovative | Asset Driven | Brandstrength Driven |
|---|------------------------------------|---------------------------------------|--|--|
| Marketing Customer perspective Greed | | | | |
| <i>Cost (Price)</i> | Skimming (<i>premium price</i>) | Upmarket | Competitive | Downmarket |
| Business & Operations Internal perspective Ego | | | | |
| <i>Suppliers</i> | Price of substitution | Availability of substitutes | Relative cost | Make or buy? |
| Finance Financial perspective Fear | | | | |
| <i>Applications¹</i> | Interest repayment | Debt repayment | Adequate reserves | Timely dividends |
| <i>Sources</i> | Protected royalties | Differential pricing | Product [concentrated] volume | Market [dissipated] volume |
| <i>Owes & Owns</i> | Intellectual protection | Intellectual capital | Assets secure for the future | Brand strength |
| <i>Measures</i> | Return on investment | Return on sales | Return on assets | Return on equity |
| People Issues Employee perspective Guilt | | | | |
| <i>Rewards & Motivators</i> | Achievement – something new | Recognition – awards etc | Power – money/status | Control – orderliness |
| Direction (Strategic Management) Learning and growth perspective Ignorance | | | | |
| <i>Benefits gained by Synergy</i> | Technological linkage | Market linkage – similar users | Product linkage – similar prod. | Intangible linkage – e.g. brand |

¹ Not certain that this would exactly match the accountant's definition

Exhibit 3 – Measure by strategic intent

| | Growth phase | | | | |
|-------------------------|----------------------------|-----------------------------------|--|--|--|
| Strategic Intent | Inventive | Innovative | Asset driven | Brandstrength driven | |
| Advance | %T/O from new products | %T/O per product | Stockturn (or equivalent) Supplier discounts EVA/GVA? | Growth in gross turnover Supplier discounts EVA/GVA? | |
| Form an alliance | Cost share | Revenue share | Subcontract as % overhead Buy in specialist/small skills | Av. Marketing cost per outlet | |
| Bundle | GM for the total package | N/A – development too fast moving | Stock as %T/O | N/A – niche specialisation | |
| Snipe | Cost per sale per customer | MMA GP per product line | N/A – volume driven | % T/O to target groups | |
| Planning ahead | Royalty income | Asset growth | Marketing & PR as % T/O | %T/O invested in R&D | |

T/O – Turnover

GM – Gross Margin (a percentage)

GP – Gross Profit (a number)

MMA – Moving Monthly Average

R&D – Research & Development

Av. – Average

N/A – Not Appropriate

Note:

The strategic options: **Retreat** and **Capitulate** are not considered as we are considering a growing business, not one for which there might be an exit strategy, is supported externally (e.g. by government or a parent for strategic reasons) or is fighting a rearguard action in a dwindling market

Exhibit 4 – How the organisation might evolve

A hypothetical dynamic balanced scorecard for a music band, moving through the various stages of growth from 'discovery' to 'the best of ...' Madonna is a good example

Taking into account the key stakeholders, the need for sustainability and to provide a return to the investors in the business

Including the four cornerstones of the marketing process

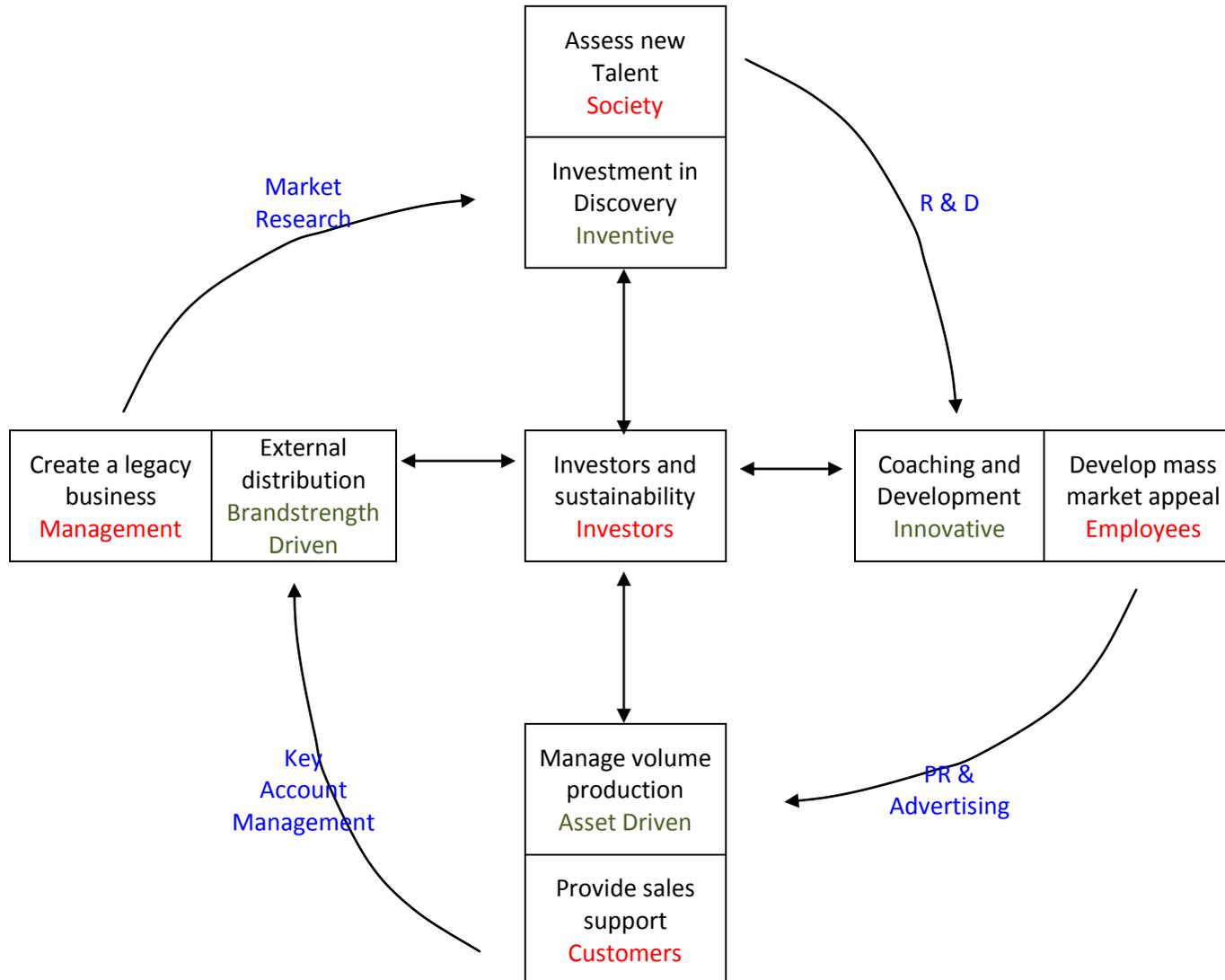


Exhibit 5 – The key reports from Profit & Loss and the Balance Sheet

From Profit & Loss

Turnover – also Income

Cost of materials

Gross Margin – Turnover less the cost of materials as a percentage of turnover (a ratio)

Gross Profit – the money left, having bought the materials (a figure)

Cost of overheads

Cost of wages (include NI and tax)

Cost of drawings (include dividend, bonus and pension fund)

Cost of administration (16% - 25%)

Net Profit – Gross Profit less all costs except materials (a figure)

Net Profit Margin – Net Profit as a percentage of turnover (a ratio)

From the Balance Sheet

Trade Creditors – who I owe (from current liabilities)

Trade Debtors – who owe me (from current assets)

Stock value, based on materials buying price (not on selling price of finished articles)

Current assets (stock, debtors and cash)

Current liabilities (creditors, expenses, tax and VAT)

Other measures – negative ones; things to look out for

These may be related to overall corporate management. The main financial pointers that come from these are:

- Decreasing profitability – at both Gross Margin and Net Margin level
- Decreasing sales volumes at constant prices
- Increase in debt
- Decrease in liquidity
- Rapid employee turnover, especially management
- Declining market share
- High cost structure relative to competition
- Over trading

Exhibit 6 – Some basic figures and the means to calculate key ratios – see also below

Profit & Loss Account

| | £ | | | |
|---|--------------|---|-------------------|--|
| Turnover (Sales, Income) | 1,000 | A | | Units sold x income per unit |
| Cost of goods (materials etc) | 200 | B | | Used to calculate stockturn |
| Cost of services (consultants etc) | 75 | C | | |
| Gross Profit | 725 | D | A - (B + C) | Used as basis for overhead management ² |
| Gross margin | 72.5% | E | D / (A - (B + C)) | |
| Overheads | | | | |
| Drawings (inc. Pension NI etc.) | 75 | F | | How much the boss is taking from the business |
| Wages | 200 | G | | |
| Admin | 150 | H | | |
| Marketing & Sales | 50 | I | | |
| Other costs | 200 | J | | |
| Total Overhead | 675 | K | F+G+H+I+J | |
| Net Profit before tax & Interest | 50 | L | D - K | |
| Net Margin | 5% | M | L / A | |

Balance Sheet – the figures used for operational financial management

| Assets (£) | | | Liabilities (£) | | |
|---|------------|---|---|------------|---|
| <i>Fixed Assets</i> – hard to sell if in trouble e.g. | | | <i>Long-term Liabilities</i> | | |
| Property | 250 | N | Loans | 10 | T |
| Fixtures & Fittings | 25 | O | Mortgages | 25 | U |
| Vehicles | 50 | P | Leases | 15 | V |
| <i>Current Assets</i> – can be fairly readily realised e.g. | | | <i>Current Liabilities</i> – can get you into trouble | | |
| Stocks | 15 | Q | Accrued expenses | 15 | W |
| Trade debtors | 175 | R | Trade creditors | 60 | X |
| Cash | 5 | S | Tax and VAT | 20 | Y |
| Net Current Assets | 195 | | Net Current Liabilities | 95 | |
| Total Assets | 520 | | Total Liabilities | 145 | |

Additionally:

| | |
|--|------|
| Number of employees | 12 |
| Number of outlets | 4 |
| Interest payments per year | £65 |
| Capital repayment per year | £115 |
| Cost of Intellectual Protection (patents etc.) | £35 |
| Royalty income from Intellectual Protection (IP) | £150 |
| Costs of filing, servicing and protecting IP | £25 |

² Used to avoid fluctuating services and materials prices

Calculations – Using the Profit & Loss Account and Balance Sheet figures above. Some of the ratios are already included in the P&L and Balance Sheets. Please note that these ratios might be calculated in slightly different ways by different people; the key is to **maintain consistency** and always be suspicious if the parameters used in calculation are changed (however plausible the reason).

All companies

| The Measures | Calculation |
|---|--|
| Moving Monthly Average (MMA) | $(Mo1 \text{ to } Mo12)/12, (Mo2 \text{ to } Mo13)/12, (Mo3 \text{ to } Mo14)/12$ etc. |
| Wages costs per employee | Gross Profit/No. Employees: £725/12 = £60.42 |
| Drawings as a proportion of Gross Profit | $(F/D) \times 100: (75/725) \times 100 = 10.3\%$ |
| Administration as a proportion of Gross Profit ³ | $(H/D) \times 100: (150/725) \times 100 = 20.6\%$ |
| Debtor Days – how long to get paid | $(R/A) \times 365: (175/1000) \times 365 = 64$ days to get paid |
| Creditor Days – how long we take to pay | $(X/(B+C)) \times 365: (60/(200 + 75)) \times 365 = 79$ days to pay suppliers |
| Working Capital – a measure of creditworthiness | Current Assets – Current Liabilities: £195 – £95 = £100 |
| Capital Cover | $(\text{Working Capital}/(A-L)) \times 365: (100/(1000 - 50)) \times 365 = 38$ days |

³ Many companies will measure admin as a proportion of turnover, which leaves the calculation more subject to price fluctuations and promotional activity

Specific to types of company

| The Measures | | What it tells us | Calculation |
|--|-----------------------------|---|---|
| <u>Inventive Companies</u> | | | |
| | Development Cost Recovery | Moving Monthly Average Gross Profit | MMA (see above) £D |
| | Interest Repayment | The level of dependency on the bank | (Loans + Mortgages ⁴)/Gross Profit: $(10 + 25)/725 = 4.8\%$ |
| | Development Success | Income from Royalties as a proportion of Turnover | $(150 - 25)/A\%: (125/1000) \times 100 = 12.5\%$ |
| <u>Innovative Companies</u> | | | |
| | Growth in net worth | How good an investment is the organisation | £ MAA (Total assets – Total liabilities) |
| | Debt Repayment | How well the organisation is managing borrowings | (Interest + Capital repayments) / Turnover: $((65 + 115)/1000) \times 100\% = 18\%$ |
| | Movement in stock value | Levels of obsolescence (by product line by time) | MMA Stocks (Q) |
| <u>Asset Driven Companies</u> | | | |
| | Return on Assets | How good the organisation is as an investment | Net Profit/(Net Assets – Net Liabilities) $50/(520 - 145) = 13.3\%$ |
| | Overhead as a % of turnover | The efficiency of the production process | (Total Overhead (K) / Sales (A)) x 100: $(675/1000) \times 100 = 67.5\%$ |
| | Stock value in days | How efficient is the production process | (Stock value (Q) / Cost of Materials (B)) x 365: $15/200 \times 365 = 27$ days |
| <u>Brandstrength Driven Companies</u> | | | |
| | Cost per new customer | Cost of business growth | MMA Units sold/MMA marketing & Sales costs (taken from A & I) |
| | Brand support & development | Investment in sustainability | Marketing & Sales as a % of turnover (I/A) x 100% $(50/1000) \times 100 = 5\%$ |
| | Outlet success | Which outlets are successful and which need help | Net margin (M) per outlet |

⁴ Come into ‘other costs’ in the Profit & Loss statement above

Conclusions

Good financial management involves considering the business as a whole and recognising where it is in its growth pattern, strategic intent and industry sector.

Some financial measures are useful to all companies, some are specific to companies' strategy, growth or sector

Exhibit 3 adds an extra dimension with points to consider in preparation for the next phase of growth:

- Inventive – Innovative Royalty income, sustainable value
- Innovative – Asset Driven Asset Growth, supporting the coming borrowings
- Asset Driven – Brandstrength Driven Marketing & PR, supporting brand development
- Brandstrength Driven – new business development %Turnover invested in R&D, extending the business

The purpose is to measure as little as possible consistent with good management and good governance

Most financial models come from major corporates when the biggest number of organisations are SMEs, most with very simple accounting requirements and many with incomplete accounts

Addendum

Some measures complement the financial measures and are helpfully used alongside them to act as checks and balances to ensure the financial interpretation is sound.

For example, an alternative measure of Brandstrength may be the ratio of customer compliments and complaints compared to the number of units sold – captured by sales and marketing, not by finance – emphasising the requirement for departments to work together to embrace the entire organisation.

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