MANAGEMENT TOOLS

It was stated earlier that a business plan is an excellent internal management tool and decision-making guide. Business managers need to be aware that there are management tools available and that they need to make use of them in order to achieve success in their business.

Beside the business plan other management tools are available:

- Financial statements
- Budgets
- Management reports
- Management meetings
- Ratio analysis

Financial Statements

The financial statements of a business consist of at least an income statement and a balance sheet. The income statement records the operating activities of the business for a particular period, for example a month. The balance sheet records the financial position of the business at a particular point of time, such as at month end. In order to understand financial statements it is necessary to know what makes up the financial structure of a business

Financial Structure of a Business

The financial structure of a business is divided into three value classifications, namely, Assets, Liabilities and Equity. These aspects of the business change continuously as business decisions are made and the financial statements are used to measure these values for a particular period and at a particular time.

Assets

Assets are those physical or financial values that a business owns. Whether it be machinery used for production, brandname, debtors' book or cash in the bank, these are things over which the business has control.

Current Assets

Some of the asset values change more rapidly than others. Those that are expected to change within a twelve month period are classified as current. Examples are cash in the bank, inventory and debtors balances.

Fixed Assets

Fixed assets are those assets that are held over the longer term such as machinery, land and buildings or long term investments. They are necessary to enable the business to continue operating.

Liabilities

Liabilities are the funds obtained by borrowing from third parties such as banks or by extending credit terms with suppliers.

Liabilities have a long term and a current classification. Amounts expected to be repaid over a twelve month period are current. Borrowings over a longer period are classified as long term.

Equity

Equity is the funds the owner has contributed to the business by way of cash or accumulated profits retained in the business. This is the owner's investment in the business.

The Balanced Equation

The total assets of a business will always equal the liabilities and equity. The balance sheet will give a measure of this equation at a particular point in time.

The Profit Making Activity

The main goal of every business is to make a profit and the extent to which this has been achieved is measured by the income statement over a year or a month or whatever period is desired. The making of a profit, however, must be planned and continuously managed in order to achieve success. Profit has two components namely revenue (sales) and expenses (costs) and both components need to be managed well.

Plan for Profit

In determining the price for goods, the market demand, competitor's prices or a desired mark up may all be factors, but the ultimate determinant is cost. Have all relevant costs been taken into account? Obviously you need to be realistic. If your costs are too high they must be reduced before arriving at your mark up. Every profit plan will include at least the following steps.

- A profit goal
- A planned volume of sales
- Costs for this volume of sales
- Comparison of estimated profit to profit goal

The outcome of these steps will determine whether alternatives should be considered, such as, a change in volume of sales and how this affects costs or profit.

Managing for Profit

Profit plans need to be implemented and monitored and this requires a system of operating control.

All control systems have at lease five steps:

1. Set up performance standards
2. Measure actual performance
3. Compare actual performance with planned performance
4. Determine if variances are acceptable
5. Take corrective action

Some methods of control:

- Observation
- Use of reports
- Budget analysis
- Management meetings

A manager needs to have complete knowledge of what is happening in his business. One of the ways he can do this is by visiting various departments and observing. For locations out of town use of written reports may be a means of control, for example, weekly sales reports, cash reports, cost reports etc. One of the more important control methods, however, is the annual budget. Once a year projections are made by each division of the business of income and expenditure for the next twelve months. This is set out in a document called the annual budget. These budgeted amounts are then compared against the actual amounts reflected in the financial statements during the course of the year. Variances between actual and budget must then be analysed at a monthly management meeting and corrective action decided upon. The more important budgets are the capital budget, operating budget and the cash flow budget. Examples of budgets (forecasts) will be found in the sections on preparing a business plan.

Evaluating the Financial Condition of the Business

In the previous section we have been considering a need to plan and manage for profit. However, it is essential also to evaluate the financial position of the business on a regular basis as part of management. Having achieved planned profit does not necessarily mean cash in the bank. Customers may not pay their accounts or cash may be tied up in excessive inventory on hand or excessively high cost of borrowing may be draining cash. Whether the business is financially sound must be considered. This evaluation requires establishing relationships, called ratios, between two or more variables from the financial statements of the business. The ratios are compared with those of prior periods or with similar industries. Large fluctuations indicate further investigation is necessary.

Ratio Analysis

The approach is to ask yourself some questions about your business and seek the answer from an analysis based on the financial statements. Here are some questions you may ask and the relevant ratios that may be used in the analysis:

How satisfactory are the profits?

Profitability ratios are measured against sales and against investment.

- Gross profit as a percentage of sales measures the profitability of trading.
- Net profit as a percentage of sales measures the profitability of the business as a whole.
- Return on investment is calculated by dividing profit after tax by owners equity and is an indication of what return the owners are earning from their investment in the business.

Your expectations or prior achievements will inform you whether your business is performing or not.

Can the Debts be Paid?

Liquidity ratios indicate whether sufficient current assets are available to pay current liabilities.

$$\text{Current ratio} = \frac{\text{current assts}}{\text{current liabilities}}$$

A ratio of 2 to 1 is the norm

$$\text{Quick ratio} = \frac{\text{current assets - stocks}}{\text{current liabilities}}$$

A ratio of 1 to 1 is usual

Cash flow problems will quickly be evident from the ratios.

How efficient are the assets?

- Debtors collection period

  $$\frac{\text{Debtors x 365}}{\text{Credit sales}}$$

  Days in excess of your normal credit terms is indicative of poor debt management.

- Stock turnover

  Stock is held as a temporary measure until sold. Therefore stock should turnover within a reasonable period. This ratio is an indication of the number of times stock is moving through to sales.

  $$\text{Stock turnover} = \frac{\text{Cost of sales}}{\text{Stock}}$$

  A poor ratio may point to obsolete stock or overproduction.

- Creditors days

  $$\frac{\text{Creditors x 365}}{\text{Cost of sales}}$$

  This ratio is an indication of the extent to which trade credit is utilised. A high number of days may point to cash flow problems or poor management of payables.

What is the relationship between owners funds and borrowed funds?

This relationship is referred to as leverage. If owners supply only a small amount of total funds, their risk is less. On the other hand, funds borrowed from outsiders come at a cost, namely interest. Provided more interest is earned on the borrowed money than interest paid, it is more beneficial to borrow money. This effect is referred to as gearing.

The measure of extent of outside borrowings is the debt equity ratio.

$$\text{Debt equity ratio} = \frac{\text{all borrowings}}{\text{owners equity}}$$

A ratio of between 1,5 and 2 is usually acceptable, indicating that outside funds can be twice owners funds for strong companies.

$$\text{Interest cover ratio is the ratio of } \frac{\text{Profit before interest paid}}{\text{Interest paid}}$$

This is an indication of the extent to which profits can decline before the business would be unable to pay its interest on borrowed funds.

Other ratios and tools are readily available but those discussed are adequate for most businesses, keeping managers informed enough to guide their business to success. Other ratios have been included under the Financial Template section.