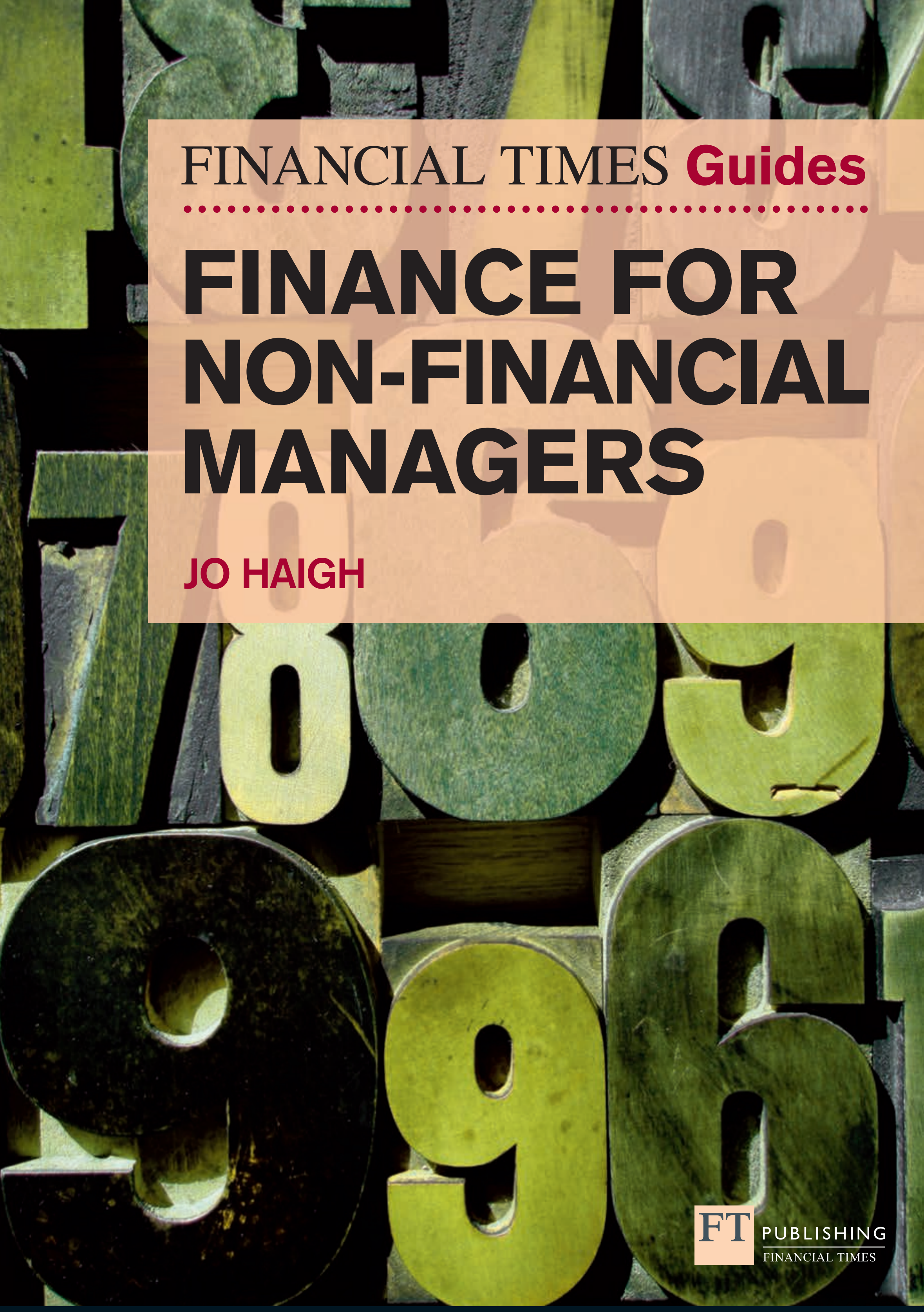

FINANCIAL TIMES **Guides**

FINANCE FOR NON-FINANCIAL MANAGERS

JO HAIGH

FT PUBLISHING
FINANCIAL TIMES

ALWAYS LEARNING

PEARSON

Praise for *The Financial Times Guide to Finance for Non-Financial Managers*

'Jo Haigh is a master of translating complex accounting terms into a language that even the numerically challenged understand. Having heard Jo speak countless times, and witnessing the audience adore Jo's straight talking speak – from young to old, rich to poor, start-ups to successful businesses – Jo is the darling of the owner/manager world.

The book is an extension of her renowned training courses and talks and is a must for those that just need to understand the critical aspects of numbers that then allows them to run their business efficiently. Having graduated from INSEAD, this book should be on the compulsory reading list for all MBA faculty. Jo's previous publications are a delight and this one is no different!'

Charlotte Mason, founder SiliconIOM and INSEAD EMBA07

'As a Managing Director of a manufacturing business with a manufacturing background I am indeed the ideal subject for a book like this.

A business is not something to be gambled with – just as we need to know how to maintain our motorcar, we need to know how to keep our business in good financial health and input from Jo Haigh goes a long way to focusing traditionally non-financial managers on the things that matter!'

Peter Holmes, Managing Director, Anchor Magnets Ltd

'Whatever your profession there is one certainty of business life: you will never get to the top of any business, any public sector organisation or any charity without a confident understanding of the financial figures. I work with Boards and senior managers; I have worked with Jo. She is an impressive business leader who knows her numbers and has practically translated that knowledge into business success. Bottom line? She knows how to inspire that confidence because she knows what she is talking about. Top line? It may be what you do after the sums that matters, but if you don't know your numbers you are not even in the game. If you want to get ahead, do the sums and buy Jo's book!'

Squadron Leader John Peters, MBA MRAeS BSc (Hons) RAF Rtd.
leadership and business coach, author of **Tornado Down**

When business is tough a seemingly easy option is to undercut the competition on price. But Tables 4.1 and 4.2 show that both the options of increasing prices and reducing prices have certain ramifications.

Such decisions may be outside your control although ultimately an insight into their impact is certainly of value and may help you to influence the process.

If you increase or cut your prices by the percentage in the left hand column and assume your margin is one of those in bold at the top of each table the resulting figures will show you know how much more or less business you need to stay stable.

Table 4.1 Increase in business needed when cutting price

IF YOU CUT YOUR PRICE BY	**WITH YOUR PRESENT GROSS PROFIT BEING**						
	10%	**15%**	**20%**	**25%**	**30%**	**35%**	**40%**
5%	100.0%	50.0%	33.3%	25.0%	20.0%	16.7%	14.3%
6%	150.0%	66.7%	42.9%	31.6%	29.0%	20.7%	17.6%
7%	233.3%	87.5%	53.8%	38.9%	30.4%	25.0%	21.2%
8%	400.0%	144.3%	66.7%	47.1%	36.4%	29.6%	25.0%
10%	–	200.0%	111.0%	66.7%	50.0%	40.0%	33.3%
11%	–	275.0%	122.2%	78.6%	57.9%	45.8%	37.9%
12%	–	400.0%	150.0%	92.3%	66.7%	52.2%	42.9%
15%	–	–	300.0%	150.0%	100.0%	75.0%	60.0%
16%	–	–	400.0%	117.8%	144.3%	84.2%	66.7%
18%	–	–	900.0%	257.1%	150.0%	105.9%	81.1%
20%	–	–	–	400.0%	200.0%	133.3%	100.0%

Table 4.2 Decrease in business possible when increasing price

IF YOU INCREASE YOUR PRICE BY	WITH YOUR PRESENT MARGIN BEING								
	20%	**25%**	**30%**	**35%**	**40%**	**45%**	**50%**	**55%**	**60%**
2%	9%	7%	6%	5%	5%	4%	4%	4%	3%
4%	17%	14%	12%	10%	9%	8%	7%	7%	6%
6%	23%	19%	17%	15%	13%	12%	11%	10%	9%
8%	29%	24%	21%	19%	17%	15%	14%	13%	12%
10%	33%	29%	25%	22%	20%	18%	17%	15%	14%
12%	38%	32%	29%	26%	23%	21%	19%	18%	17%
14%	41%	36%	32%	29%	26%	24%	22%	20%	19%
16%	44%	39%	35%	31%	29%	26%	24%	23%	21%
18%	47%	42%	38%	34%	31%	29%	26%	25%	23%
20%	50%	44%	40%	36%	33%	31%	29%	27%	25%
25%	56%	50%	45%	42%	38%	36%	33%	31%	29%

So if you cut your price by 10% and your margin is 35% you need to sell 40% more product to stay in the same place.

Similarly, if you increase your price by 10% and your margin is 35% you can sell 22% less and stay in the same place.

Driver impact

Chapter 5 examines the critical differences between profit and cash but in terms of business drivers these two have some correlation.

Profit driver

In theory it is entirely possible to make a lot of profit; buying cheap and selling high is a good start.

Cost of goods	£100
Sale price	£500

Your profit and loss account on this simple equation looks as follows;

Sale	£500
Cost of goods	£100
Gross profit	£400
Gross margin	80%

Not a bad start provided that:

a You can buy at that price

b The competition don't undercut your price.

If they do undercut your price you can choose to cut yours again. But if they cut theirs once more then it becomes a price-cutting war (with the customer eventually winning). Someone in the selling chain will reach a point where they cannot decrease their price any more. This decision will possibly be a sales team one but the finance department will need an explanation. They will want to be confident that the price cut will increase sales volume at best and, at worst, retain market share.

The problem with a price war is further exacerbated on two fronts:

1. Stock costs and stock turnover: if you have bought in a certain amount of stock to cover anticipated demand you have to store it. This has a cost attached to it. You also have to pay for it, perhaps in advance of making a sale to a third party. You may also have to write off any obsolete stock if the product you sell has a finite life.
2. Will a reduced gross profit provide enough income to pay the overheads of the business and make a level of acceptable net profit? Look again at Table 4.1.

For example if target net profit is 10% then the business must look like this:

Sale	£500	
Cost of goods	£100	
Gross profit	£400	80%
Overheads	£350	
Net profit	£50	10%

Any reduction in gross profit needs to be handled in the following ways:

1 Increase sales
2 Reduce costs of goods sold i.e. agree a cost reduction with your supplier
3 Cut overheads.

All of these are possible but require specific consideration.

1 Increasing sales will mean increasing stock levels unless you work on JIT or consignment stock: there will therefore be a cost attached to higher stock levels.
2 Reducing prices from your supplier may or may not be negotiable and even if it is there may be a *quid pro quo* requirement such as them wanting regular or proforma payments.
3 Cutting overheads is, of late, a common activity and does enable you to technically maintain a net position but businesses need a minimum level of overheads to operate effectively. In addition some cuts can take time to be effective. For example relocation may cut the fixed cost of rent but the price of relocating may in the first instance create less not more profit.

Such profit-related decisions take time to

1 Maintain

and

2 Implement.

They may also have a knock-on effect on other areas – not least service levels falling or quality not being maintained. Both of these are serious consequences for any business that sits in a highly competitive position.

Cash driver

Sales are vanity, profit is sanity and cash is absolutely essential – this is a well known business saying.

An organisation that chooses cash as a significant strategic financial driver has possibly done so because either its cash reserves are poor or the possibility of raising more money from traditional banking resources is unlikely or difficult.

Businesses by and large do not fail because they are not profitable but because they have run out of cash. Without cash it is simply not possible to trade (see Chapter 5).

Some businesses need less cash than others due to the nature of their trade and, conversely, some businesses need more working capital (the capital that is used in the business on a daily basis to fund stock and debtors).

A service business, for example one selling time or services as opposed to goods, will not have its cash tied up in goods on pallets in its warehouse. That does not mean it doesn't need cash to fund its WIP (unbilled time for work carried out), it's just that it can invoice such time regularly and so free up this cash by billing and, of course, insisting its customers pay to term.

In order for a business to be cash-driven, releasing cash so it can be utilised will require initiatives such as early or prompt payment discounts.

For this to be effective the customer has to see some benefit in paying. Consider the result of the following formula before confirming your offer:

$$\frac{\text{365 (days of the year)}}{\begin{array}{c}\text{Number of days difference between}\\ \text{standard payments and early payments}\end{array}} \times \text{Discount}$$

If you offer a 2% discount for payment in 10 days, when the norm is 30 days, and payment is made in 30 days, the 2% becomes an interest charge. If money is borrowed at 2% for 20 days, this is equivalent to an annual rate of 36%. Your customer should definitely pay promptly in this case, but the question is, does it achieve your objective of creating cash?

There are a number of other activities to create cash in addition to those mentioned above.

Collecting your debtors quickly and paying your suppliers slowly will create cash, although too much disparity between the two will not help your business's reputation. The concept of paying for goods and services after you have been paid is a well established practice, as indeed is a proforma payment agreement i.e. paying for the goods and services before you even utilise them.

A business that is driven by cash may choose not to tie up any of this precious commodity in fixed assets of any kind so it may rent its buildings and hire its fixtures and fittings.

Companies such as Regus, the office-hire and virtual office business, are based on just that principle: paying for what you want only when you actually need it. Such flexibility is particularly attractive for early stage businesses that tend to be cash poor.

Using CID (confidential invoice discounting) or a factoring agreement (both defined in Chapter 3) also create access to cash, although in themselves these do not create more cash. For a rapidly growing business such a business process can be very beneficial provided the costs are acceptable.

Using associates or subcontractors as opposed to employees can create cash as at the very least the business will save on employer National Insurance contributions (NIC): this is currently as much as 12.8%.

However, you should be careful not to be caught out by HMRC regulations around the utilisation of associates. A particular piece of legislation seeks to eliminate the avoidance of tax and NIC by determining if the associate being treated as such by the company is in fact an employee. The rules are complex and guidance from your accountant or tax advisor is advisable. The following are some of the issues that would be considered in assessing whether or not an associate is, in the eyes of the HMRC, actually an employee:

- Whether the associate personally performs the service
- Whether the services are provided directly with the client or under agreements involving an intermediary
- Whether the circumstances are such that if you had provided the service directly to the client under a contract between you and the client you would have been regarded, for income tax purposes, as an employee of the client and/or for NIC purposes as employed.

Paying staff on commission only (or largely) on **paid-for** transactions is very effective. This way you don't pay your sales person until the opportunity or goods they have sold have been paid for by the customer.