ICB Members' Newsletter July 2006

You will recall last month that we focused on the accounts of Pauline Musgrave who runs a tea shop/cafe in Rural North Yorks.
The case study set tasks on interpretation of the financial statements and some break-even analysis on three additional ventures she was in the short term considering.
The analysis of the accounts for 2005 are given together with a comparison for 2004.Also shown are calculations and comment on the additional business ideas.
We also answer Pauline's question "I have made a profit of £16780 for the year but my cash and bank balances have fallen by £1260---- why?"

Here we show a modified layout of a cash flow statement to suit the needs of an unincorporated business. The accounting standards on this concept relate to the requirement for Ltd companies.

To follow the two steps in this process you need to refer to Pauline's accounts for 2004 and 2005 that we featured in the introduction to last months case study.
If any of our readers wish me to cover the Cash Flow statement further to account for the needs of a Ltd Company we can do so in a later issue of the newsletter.
Please let me know.
If any of you have yet to take your annual summer leave, have a peaceful and happy holiday.
Philip E Dunn
Editor

Pauline Musgrave

The analysis of Pauline's accounts for year ended 30 September 2005 and comparison with 2004 shows:

Pauline Musgrave Tea Shop			
Ratio	**2004**	**2005**	**Comment**
% Gross Profit to Sales	37.57%	39.17%	(1)
% Net Profit to Sales	7.86%	9.93%	(2)
Current Ratio	4.48 : 1	3.90 : 1	(3)
Acid Test	2.86 : 1	2.22 : 1	(4)
Stock Turnover	1.1 months	1.44 months	(5)
Wages % of Sales	18.15%	18.65%	(6)
Asset Turnover	4.33	4.85	(7)
Return on Capital Employed	34.05%	48.23%	(8)

Comments (per notes)

(1) An increase in profitability here that may be affected by one or more of the following factors:

- an increase in selling prices
- a change in the mix of sales, with a shift to higher sales on meals and snacks with a more favourable contribution to sales ratio
- better buying policy, access to cheaper prices for ingredients used in meals and snacks

(2) The increased profitability is also highlighted here. The benefit derived from the increase in the relationship of gross profit to sales reflects here as the expenditure on wages and overheads has been controlled and is at a similar level to that of 2004.

(3) The current ratio indicates a most sound level of liquidity, although there has been a marginal decline over the period.

(4) **Acid Test**

This is the true test of liquidity. 2.22 : 1 indicates that Pauline will have no difficulty meeting the demands from creditors in the short run.

The liquidity has fallen due to the increased level of stockholding in 2005.

(5) Pauline is holding approximately 1.44 months worth of stock and is an increase in holding over the previous year as per note made in (4) above.

(6) **Wages and Salaries % of Sales**

This expenditure is a major cost to the business and the additional revenue has been generated with little additional expenditure on wages and salaries.

(7) **Asset Turnover**

There has been a marginal increase in the utilisation of assets over the period. There has been a greater amount of revenue generated in relation to the investment, although the level of investment has fallen due to the decrease in the NBV of the fixed assets.

(8) The overall increase in profitability is reflected here in the primary ratio, return on capital employed. A most healthy return on investment.

Response to Pauline's new ventures.

- **Speciality Ice Cream Project**

  For each £100 worth of stock at cost Pauline buys only £98 is saleable.

  Therefore for each £100 of stock at cost we would generate £122.50 of revenue in the form of sales.

  % Profit (Contribution) to Sales

  $$\frac{22.50}{122.50} \times 100 / 1$$

  $$= 18.36734\%$$

  Fixed Costs: (Incremental Costs)

	£
Depreciation of freezer	300
Annual maintenance and insurance	100
Electricity	300
	£700

  Break-Even Level in Revenue (Sales)

  $$\frac{\text{Fixed Costs}}{(C/S)} = \frac{700}{(22.5 / 122.5)}$$

  $$= \frac{700}{0.1836734}$$

  $$= \underline{£3811}$$

  ie: £3811 x 18.36734%

  = £700 Contribution or gross profit to cover fixed costs

- **Children's Play Area Project**

  Incremental Costs (Fixed Costs)

	£
Depreciation	3500
Maintenance	650
Insurance	850
Staffing	8000
	£13000

  Contribution per child day £5

Break-Even Point

$$\frac{\text{Fixed Costs}}{\text{Contribution per Child Day}}$$

$$= \frac{£13000}{£5}$$

= 2600 / 40

= 65 children per week

- **Queen's Birthday Tea Project**

  Incremental fixed costs £100

  Contribution per tea

  = £7.50 - £3.50

  = £4

Break-Even Point

$$= \frac{\text{Fixed Cost}}{\text{Contribution per Unit}} = \frac{£100}{£4}$$

= 25 customers

Pauline Musgrave – A Cash Flow Tea Room Perspective

Following from your analysis of Pauline's accounts and the response to proposed ventures, she asks the question, why is it that having made a profit in 2005 of £16780 my cash and bank balances have fallen £1260?

This is a question often asked by non-financial managers.

Both the Accounting Standards Board in the UK (ASB) and the International Accounting Standards Board (IASB) have accounting standards that deal with the preparation of a cash flow statement – FRS 1 (ASB) and IAS 7 (IASB).

To answer this question we need to draft a cash flow statement for 2005 based on Pauline's accounts.

It has been said that the cash flow statement **"provides the link between the balance sheet at the start of the period, the profit or loss for the period and the balance sheet at the end of the period"**.

Step 1: we need to prepare the:

Reconciliation of net profit from operations to net cash flow from operating activities:

	£
Net profit for year	16780
Add deprecation (1)	3975
Cash flow from trading	20755
adjustments for:	
Increase in stock (2)	(3000)
Increase in debtors (3)	(1100)
Increase in creditors accruals and VAT (4)	1585
Net cash flow from operating activities	18240

Notes:

(1) Depreciation is added back to profit for year as "Depreciation is a non-cash item"

(2) (3) (4) these items are based on the differences between the opening and closing balance sheets.

Adjustments are then made for the changes referred to in the note above.

A further £3000 has been tied up in stock and has a negative effect on cash flow. Debtor balances have increased by £1100 and this also has a negative effect on cash flow.
However, creditors have increased by £1585 this has a positive effect as the business is using funding from its suppliers and other creditors.

The overall net cash flow from operating activities is therefore £18240, which note differs from profit for year.

Step 2, we can then prepare the cash flow statement starting with £18240.

The layout is modified from the accounting standards referred to earlier to suit the needs of an unincorporated business.

Cash Flow Statement

	£
Net cash flow from operating activities	18240
Cash flow from investing activities (5)	
Acquisition / disposal of fixed assets	-
Cash flow from financing activities (6)	
Capital introduced	-
Loans	-
Drawings for year	(19500)
Net increase / (decrease) in cash in year	£(1260)
Cash and bank balance at start	13350
Net decrease in year	(1260)
Cash and bank balance at end of year	£12090

You will note the objective here is to reconcile the increase or decrease in cash for the year with the movement in cash and bank balances over the same period.

You will note on the cash flow statement (5), (6) there is facility here for showing acquisition and disposal of assets and its effect on cash flow; together with a facility for showing any additional funding in the form of capital introduced and loans.

As drawings are a reduction in capital (proprietors) then these are shown here under the heading, cash flow from financing activities.

You can see here that the drawings of £19500 are offset against the net cash flow from operating activities £18240 – the net effect, being a fall in liquidity of £1260.

