



FINANCE INDUCTION PACK

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Introduction

The Finance Team and the sub teams of Invoicing, Cashing Up & Payroll ensure that all transactions are processed in a timely manner to enable the business to provide financial information to its Members and relevant external bodies (i.e. Companies House & HM Revenue & Customs).

Regardless of whether you may become a member of one or more of these teams, as a potential Member/Director of the business, it is also your responsibility to grasp a basic understanding of the financial reports provided. This will enable you, together with the rest of the Membership, to make informed business decisions and meet legal requirements thereby fulfilling a condition of membership.

The more detailed objectives and responsibilities of the Finance Team and its sub groups are detailed in the attached Team Charter.



The objective of this Induction Pack is to give you a basic understanding of the financial information Unicorn produces together with some indicators to help you understand what some of the figures mean. It may also be used during your time at Unicorn to find your way around information provided prior to Members' Meetings. All the latest reports are attached in the appendices. There is a lot to digest so don't worry about getting to grips with all of it from the beginning; it will simply help you access the information easily when you need it.

If you ever have any questions about any financial information produced or feel that you would like additional training, please come and ask the Finance Team for support.

Profit & Loss Account

Why do we produce a profit and loss account?

- It is a legal requirement
- It monitors our financial performance over any given period of time (quarterly and annually) against a budget produced at the beginning of that period
- It is used as a basis to calculate corporation tax on our profits
- It can be used as a benchmark against similar businesses in the same sector. How well are we actually doing in comparison?
- It can help us identify areas where improvements/savings can be made to increase our profits

For internal purposes a profit and loss account can look however you want it. An example of our latest profit and loss account is attached (see latest management accounts). The statutory profit and loss account is also attached in the annual accounts and this is a set legal format. ***Our financial year runs from 1 January to 31 December.***

Our profit and loss account can be divided into the following:

- **Gross Profit** (Sales – Cost of Goods Sold (COGS))
- **Operating Profit** (Gross Profit – Expenses)
- **Other Income & Expenditure**
- **Taxation**

Gross Profit

The gross profit section (usually at the top of the page) details the income generated from items sold less any costs **directly** related to selling those products. An example of this section is shown below:

Unicorn Grocery Ltd Profit & Loss Account

	£	£
Sales (figures generated by EPOS)		100,000
Cost of Sales:		
Opening Stock	10,000	
Purchases (including delivery)	79,250	
Wastage	100	
Packaging	70	
Closing Stock	<u>-20,000</u>	
		<u>69,420</u>
Gross Profit		<u>30,580</u>
<i>Gross Profit %</i>		30.6%

At this point it is important to introduce the concept of '**matching**'. This simply states that costs should be reflected in the same time period as the sales they helped generate. This helps us measure how much money has been spent to generate sales and avoids the timing differences between when the actual costs were incurred and when the corresponding sales were generated. As a result we are able to analyse Gross Profit more objectively.

The obvious example of 'matching' in the Gross Profit section of the profit and loss account is **stock**. We produce our annual accounts to 31 December. Imagine, in anticipation of the New Year and impending cold, we purchase and pack down 5 pallets of porridge oats (cost £3,750) between Christmas and New Year's Eve. However, by 31 December we have only sold 500 bags (income £595). The rest of the porridge is sold in the next financial year.

If we didn't make an adjustment for the fact that we still had 4,500 bags of porridge in stock (i.e. unsold) at 31 December we would show a Gross Loss of **-£3,155** (left) instead of a Gross Profit of £220 (right).

	£	£		£	£
Sales (of porridge)		595	Sales (of porridge)		595
Cost of sales:			Cost of sales:		
Opening Stock	0		Opening Stock	0	
Purchases	3,750		Purchases	3,750	
Closing Stock	<u>0</u>		Closing Stock	<u>-3,375</u>	
		3,750			375
Gross Loss		<u>-3,155</u>	Gross Profit		<u>220</u>

The gross profit that we make is directly linked to the mark up that we put on all our products. Cost price x Mark Up = Selling Price or Selling Price x 1/Mark Up = Cost. The target margins for the different areas of our business are detailed below with an example of a month's sales to demonstrate how the sales volume mix generates a Gross Profit in excess of 30.5%.

Area	Mark Up	Sales (EPOS)		Gross Profit (Profit/Sales)
		Oct-13	Cost	
Veg	1.5	127,732	85,155	33.33%
Deli	1.5	32,478	21,652	33.33%
Branded (including alcohol)	1.38	170,413	123,488	27.54%
Chilled (Fresh)	1.4	47,976	34,269	28.57%
Bread	1.25 - 1.38	13,044	9,919	23.95%
Production (min. 40p per bag):				
250g or less	1.67	29,684	17,775	40.12%
500g	1.61	23,429	14,552	37.89%
1kg	1.54	31,471	20,436	35.06%
3 - 5kg	1.33	6,507	4,892	24.81%
Sacks (i.e. not packed)	1.25	0	0	
		<u>482,734</u>	<u>332,138</u>	31.20%

We use different mark ups in different areas of the shop to try and reflect the different costs involved in bringing a product to the shop floor. However, our price is ultimately controlled by what people are regularly willing to pay. The target mark ups are the minimum we hope to achieve although we may go lower, and indeed on other products we will increase the mark up. At our current sales volumes and mix, the spread of mark ups has yielded an overall annual Gross Profit over the last 3 years (2010 – 2012) of between 30.5 and 30.9%.

Operating Profit

The ***second*** section of the profit and loss account details all other operating expenses that are deducted from gross profit to arrive at an **operating profit** (sometimes referred to as ordinary income). These are costs and expenses incurred in the actual running of the main business other than the costs directly associated with sales.

In our management accounts these expenses are detailed in alphabetical order starting with 'Accounting' and finishing with 'Waste Management.' In the annual accounts they are simply added together as 'Administrative Expenses.'

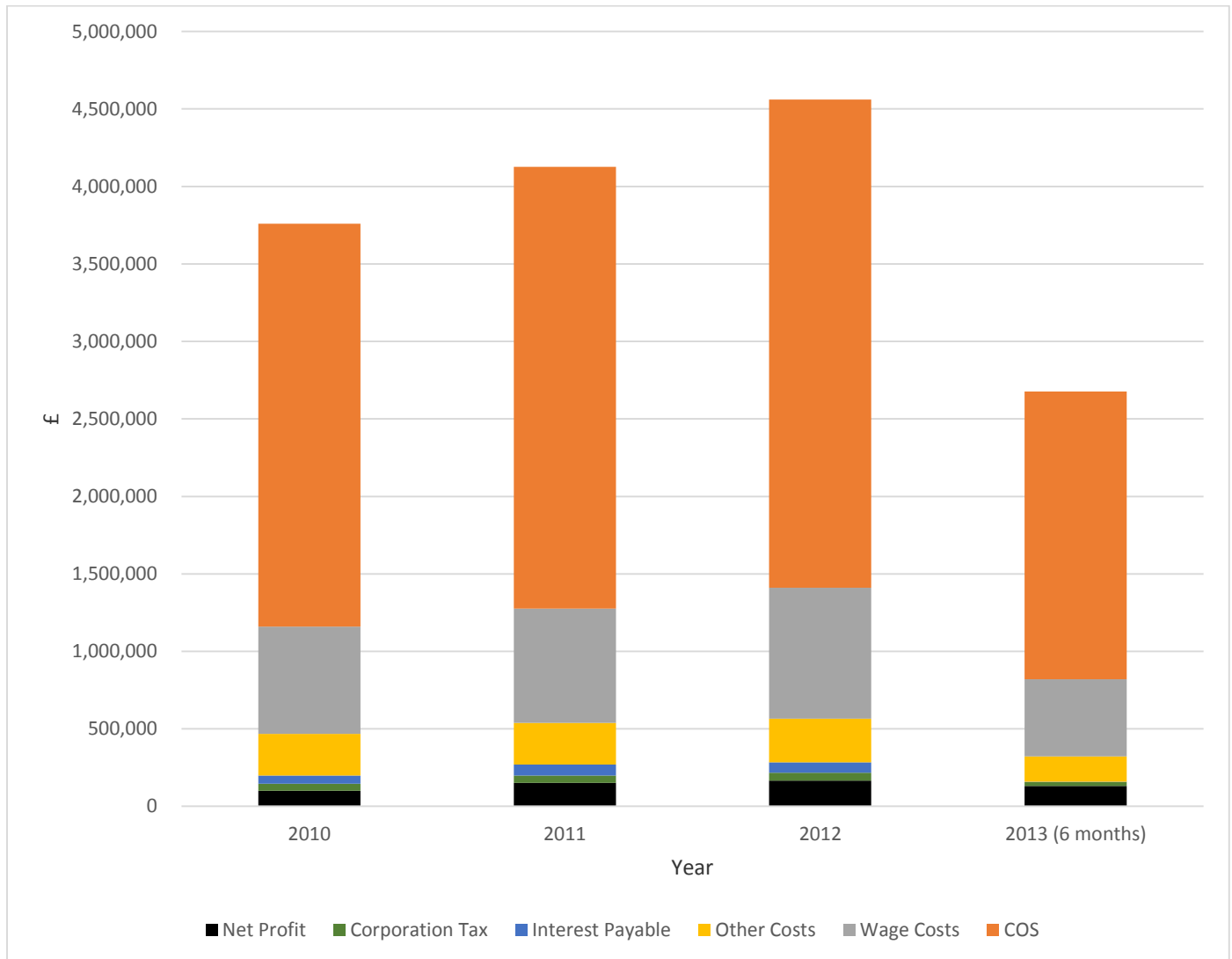
Expenses can be classified as variable, semi-variable and fixed.

Variable costs are costs that change in proportion to the sales that we make. An example of this is the credit card processing fees. We are charged for each card transaction that we process so an increase in credit card sales will lead to an equivalent increase in the card processing charges.

Fixed costs are expenses that are not dependent on the level of sales we make. They tend to be time-related, such as our Members' wage bill or our annual insurance, and are often referred to as overheads. Conversely, our casual wages are variable costs as they change in proportion to the sales we make (assuming we have sufficient Members' to run the business on a daily basis).

A semi-variable cost is an expense which contains both a fixed-cost component and a variable-cost component. The fixed cost element is the part of the cost that needs to be paid irrespective of the level of sales. The variable component of the cost is payable proportionate to the level of sales (i.e. energy costs).

Our Wages bill, however, is by far our most significant expense as demonstrated in the graph on the following page. The percentage of wage costs to total operating costs will depend on three factors: our efficiency; our ratio of member hours to casual hours; and our hourly pay rate.



The 'matching' principle is used throughout the profit and loss account. For example we pay our annual insurance premium up front in August for the period from August to July the following year. Say we pay £15,000 in August, at the end of the year we only want 5/12^{ths} of that amount to be represented in the profit and loss account in that year (i.e. £6,250). The remainder of the cost (i.e. 7/12^{ths} or £8,750) relates to the following financial year.

Other Income & Expenses

The **third** part of the profit and loss account relates to income and expenditure that isn't normally generated or incurred during the normal course of running the business.

Our **other income** includes:

- Bank Interest (derived from our cash reserves)
- Rent (cash machine and land at Glazebury)
- Share Interest (from our investments with Greater M'cr Tree Station, Chelmsford Star etc.)
- FIT payments (via our solar panels)

Our ***other expenses*** include:

- Bank Interest (on our loan)
- Loan Stock Interest (now concluded)
- 1% and 4% donations (representing 5% of the previous year's wage bill)

Tax

Last but definitely not least is the ***tax*** charged on any profit the business makes in a financial year. The corporation tax rate is currently 20% for small businesses. In the last 3 years (2010 – 2012) the corporation tax charge equates to 1.1% of sales (i.e. for every £1 of sales, we pay 1.1p in corporation tax).

Net Profit (after Tax)

Once the tax amount has been deducted we finally arrive as what is called ***Net Profit after Tax*** and this is the amount that is transferred to the Balance Sheet as a cumulative profit reserve to carry forward to the following year (see Balance Sheet).



Balance Sheet

The Balance Sheet represents a snapshot in time of our financial position. It also forms part of the annual statutory accounts and is a legal requirement.

The balance sheet has 3 main parts:

- Assets (what we own, is due to us or what we have paid in advance)
- Liabilities (what we owe; can be short-term or long-term)
- Capital & Reserves (our share capital and cumulative profits)

Assets – Liabilities = Capital & Reserves OR

Assets = Liabilities + Capital & Reserves

This second equation demonstrates how our assets are financed; through borrowing money (i.e. liability) or through reserves built up in previous years (i.e. Capital & Reserves).

Assets

The main categories of our **assets** are listed first, in order of liquidity (i.e. how easily they can be converted into cash). The table below details the assets of our business in summary form:

Balance Sheet @ 31 December XXXX

Assets

Fixed Assets (e.g. 89 Albany Road, Packing Machine, Computers etc)

Other Assets:

Investments (e.g. Greater Manchester Tree Station Share Capital)

Other Debtors (e.g. Loan to Glebelands II)

Prepayments (i.e. Insurance of £8,750)

Current Assets:

Stock (e.g. 4,500 1kg bags of porridge at cost price)

Accounts Receivable (Invoiced Sales where monies have not been received)

Cash at Bank

Triodos	(Balance on bank
Co-op	statements)
Euro	

The total of all these amounts = our **TOTAL ASSETS** (i.e. a cumulative total of what we own, our investments in other businesses, monies due to us, the cash we have in the bank and any amounts we have paid in advance).

Most of the assets in our balance sheet are stated at cost (i.e. what we paid for them) together with money owed to us and what we have in our various bank accounts. The exception to this is our fixed assets.

Fixed Assets

Fixed assets is a term used for items that are not readily converted to cash and that are not directly sold to our customers. They are items that we have bought and will use for an extended period of time (how long depends on each individual item or categories of items).

How fixed assets are treated is yet another example of the 'matching' principle. A recent example of assets purchased have been the packing machine (Plant & Machinery) at £18,500 plus VAT and numerous computers and associated software (Computer Equipment) at £4,500 plus VAT.

Both of these assets were incurred in the same year. If we were to account for them as a normal business expense through the Profit & Loss account the cost would significantly reduce our net profit in that financial year to the sum of £23,000 (the VAT element can be reclaimed). However, the generation of sales from the use of these items will continue for a number of years to come. It is therefore only 'prudent' that the cost of these items is spread over these years.

The cost of the item sits on the balance sheet and a **depreciation charge** is put through the profit and loss account each year that recognises the cost incurred by the use of each asset. The cost of a fixed asset must be charged to the profit and loss account in a manner that best reflects the pattern of economic use of the asset. The most common methods of depreciation are Straight Line and Reducing Balance.

Straight Line Depreciation

The straight line method depreciates cost evenly throughout the useful life of the fixed asset. Straight line depreciation is calculated as follows:

$$\text{Depreciation per annum} = (\text{Cost} - \text{Residual Value}) / \text{Useful Life}$$

Where the:

- Cost includes the initial and any subsequent capital expenditure
- Residual Value is the estimated scrap value at the end of the useful life of the asset. As the residual value is expected to be recovered at the end of an asset's useful life, there is no need to charge the portion of cost equalling the residual value
- Useful Life is the estimated time period an asset is expected to be used from the time it is available for use to the time of its disposal or termination of use. Useful life is normally calculated in units of years but it may be calculated based on an alternative basis

Reducing Balance Depreciation

The reducing balance method charges depreciation at a higher rate in the earlier years of an asset. The amount of depreciation reduces as the life of the asset progresses. Depreciation under reducing balance method may be calculated as follows:

Depreciation per annum = (Net Book Value - Residual Value) x Rate%

Where the:

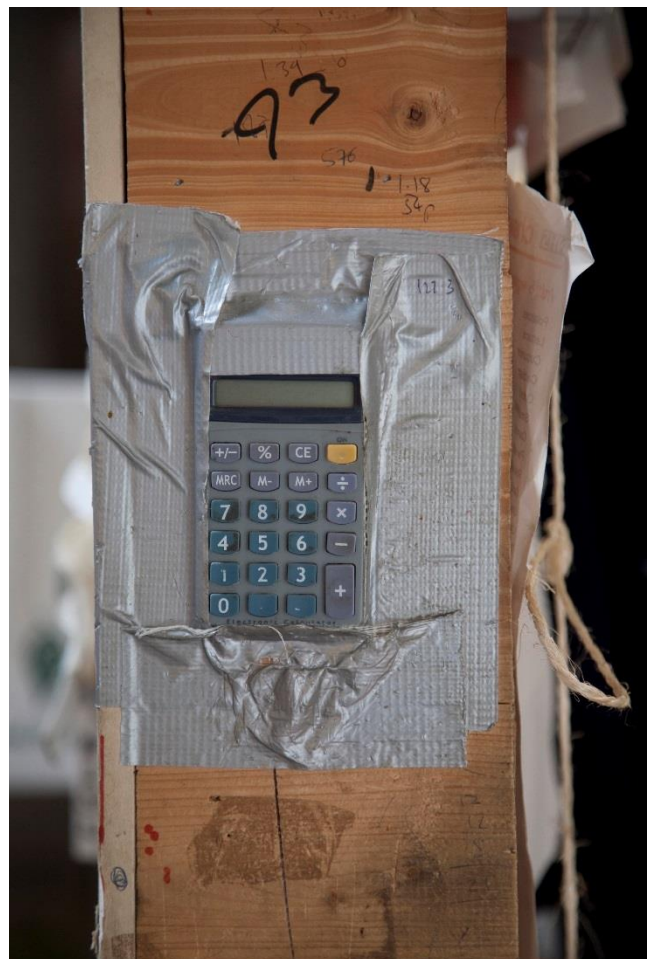
- Net Book Value is the asset's net value at the start of an accounting period. It is calculated by deducting the accumulated (total) depreciation from the cost of the fixed asset
- Residual Value is the estimated scrap value at the end of the useful life of the asset. As the residual value is expected to be recovered at the end of an asset's useful life, there is no need to charge the portion of cost equalling the residual value
- Rate of depreciation is defined according to the estimated pattern of an asset's use over its life term

The assets in the business are depreciated using the following rates and methods:

- Freehold property (2% straight line)
- Premises Improvements (20% straight line)
- Plant & Machinery (20% straight line)
- Fixtures, Fittings & Equipment (20% straight line)
- Computer Equipment (33.33% straight line)

A rate of 20% straight line means that an asset will depreciate equally over 5 years; a rate of 33.33% means that it will depreciate equally over 3 years.

In our example above, the computers purchased at the beginning of 2013 are estimated as having a useful economic life of 3 years which means that £1,500 will be charged to the profit and loss account for each of the years from 2013-2015 and by the end of 2015 the equipment will be worth £0 (i.e. will have no value in the Balance Sheet). The packing machine, however, is anticipated to have a longer useful life and at the end of the 2015 will still have a 'value' in the Balance Sheet of just over half the original cost price, with £3,700 being charged to the profit and loss account each year (with the exception of 2013 as it was purchased part way during the year).



Liabilities

Liabilities are debts and obligations of our business. Liabilities are reported on a balance sheet and are usually divided into two categories:

- Current liabilities (reasonably expected to have to be paid within a year)
- Long-term liabilities (usually expected not to be paid within the year)

The majority of our liabilities are current and fall into the following categories:

- Accounts Payable or Trade Creditors or Supplier Payments (money we owe for goods received; usually paid within a month)
- Loan Stock (2008 & 2013; now concluded and due on receipt of certificate)
- Credit Card (monthly payment)
- Corporation Tax (due 9 months after the year-end)
- PAYE/NIC (tax, employees and employers NIC paid monthly)
- VAT Liability (paid quarterly)
- Triodos Loan (paid monthly)

The only long-term liability on our balance sheet at present is the proportion of the Triodos loan that is not due to be repaid within the year. In rough terms (excluding interest) we owe in total about £65,000 but we are only repaying £666 per month so £65,000 less $(12 \times £666) = £57,000$ is due after one year.

Net Assets

TOTAL ASSETS – TOTAL LIABILITIES = NET ASSETS

The **net assets** shown by the top two parts equals the third part of the balance sheet, known as shareholders' equity/funds. This comprises:

- ***Issued Share Capital*** (each members' individual £1 share capital in the business); and
- ***Profit and Loss Reserves*** (i.e. cumulative Net Profits from previous years)

Formally shareholders' funds is part of the company's liabilities: they are funds "owing" to shareholders (after payment of all other liabilities) but in a Worker Co-operative the following applies (Cooperatives UK White Rules):

- Each member has to hold one share in the co-operative. These nominal £1.00 shares are of no value whatsoever, do not receive dividends, and are cancelled when a member leaves. The only reason they feature in the rules is to comply with the requirements of IPSA.
- Profits may be retained for reserves, distributed equitably amongst the members, or used for social and charitable purposes.

Unicorn's current cap on annual dividends is £56k per annum and therefore any additional profit is carried forward in the balance sheet (as 'retained earnings' or 'profit and loss reserves') to the following year. Over the last 17 years the business has accumulated £1.465m of profit (see note 12 in 2012 Accounts).

Cash Flow Forecast

Cash flow forecasting is a key aspect of the financial management of our business. It helps us to plan our future cash requirements (i.e. site extension) and to avoid running out of cash.

A cash flow forecast is important because it:

- Identifies potential shortfalls in cash in advance
- It ensures that the business can afford to pay suppliers and employees on time
- It helps spot problems with customer payments (i.e. how quickly they are paying their debts).

This is not a problem for us as we take most of our sales in cash/credit cards at the point of sale.

The cash flow statement includes only inflows and outflows of **cash**; it excludes transactions that do not directly affect cash receipts and payments (e.g. depreciation).

We produce our cash flow forecast on a monthly basis, for a period of up to 3 years. The latest cash flow forecasts are attached as appendices. The assumptions used in each forecast are detailed below.

- a) 2013-2016 Cash Flow Forecast (Growth; Wages Rising)
- b) 2013-2016 Cash Flow Forecast (Growth; Wages Static)
- c) 2013-2016 Cash Flow Forecast (No Growth; Wages Rising)
- d) 2013-2016 Cash Flow Forecast (No Growth; Wages Static)

Assumptions (a-d):

- 2013 Sales increased **10%** on 2012
- Cost of Sales, Wages & Other Expenses are paid for in the same month they were incurred
- GP **30.5%**
- Paid Hours = **0.019** of forecast sales (actual member hours; balancing figure = casual hours)
- Other expenses – increase **3%** year on year
- Dividends – Max. **£14k** payable each quarter
- 1 & 4% Donations – **5%** of previous years' wages
- Full capital expenditure

Assumption (a&b):

- 2014-2016 **5%** sales growth annually

Assumption (c&d):

- 2014-2016 No growth in sales

Assumption (a&c):

- Hourly Pay Rate: **2013 - £10; 2014 - £10.50; 2015 - £11; 2016 £11.50 (with casual rate at 80%)**

Assumption (b&d):

- Wage costs remain static at **£10** per hour (casual £8)

The operational cash flow of the business is detailed at the top of the cash flow as 'Operating Surplus/Deficit'. This is the cash we generate from opening up the shop and trading on a day to day basis. Below this line are one-off payments or receipts for items such as capital expenditure, loan stock repayments, corporation tax and dividends that are deducted or added to the operational surplus.

The 'running balance' figure in the bottom row of the spreadsheet forecasts on a monthly basis how much cash we anticipate to have in the bank at the end of any given month and this helps us identify any funding requirements we are likely to have in the future.

We are currently in the position of having large cash reserves built up over a number of years. However, this cash still requires management and at some point we are likely to reinvest the majority of the cash into the site extension thereby reducing our 'running balance' significantly.

The management of cash involves looking at policies aimed at managing our **current assets** (generally cash, investments and stock) and any short term financing, so that cash flows and returns are acceptable:



- **Cash management** identifies the cash balance that allows for the business to meet day-to-day expenses and ensures that any additional cash is invested to obtain the best returns in accordance with Unicorn principles that can be accessed when required. At our current level of sales our maximum and minimum current account balance ranges by about £150k in any given 2 week period. A weekly sweep to an interest bearing account ensures that anything above £150k is earning interest.
- **Stock management** identifies the level of stock that allows for uninterrupted production and minimal out of stocks but reduces the investment in commodities and storage space. But this is offset with minimising reordering costs and dealing direct with suppliers to obtain the best price.
- **Short term financing** identifies the appropriate source of financing; it may be necessary to utilise a bank loan (or overdraft) or issue loan stock if the financing is for something specific (i.e. purchase of land).

SIX KEY FINANCIAL STATEMENT RATIOS

Performance indicators or key ratios allow us to pull out information from the financial statements to understand how the business is performing overall.

They can also be used to identify important trends in the business and any areas that may need further investigation or work.

A benchmark for each of these ratios can be provided via an industry specific website:

www.retailowner.com/Benchmarks/FoodandBeverageStores/Supermarkets,GroceryStores.aspx

The last 5 years of Unicorn v Benchmark are represented in the graphs included in this section. The figures used to calculate the Unicorn figures have been taken from our annual unaudited accounts.

How can the benchmarks be used?

- **Perspective** – Calculate the ratios for Unicorn and then compare to the retail industry segment
- Use the benchmarks to **set own target ratios** depending on short, medium and long term needs or goals of the business
- Industry benchmarks are used to **assess business performance** when seeking external funding

6 Key Industry Ratios (explained below):

Profit & Loss Account:

- Gross Profit/Margin % (**Sales Efficiency**)
- Stock Turnover (**Productivity**)
- Pre-tax Profit (**Operating Efficiency**)

Balance Sheet:

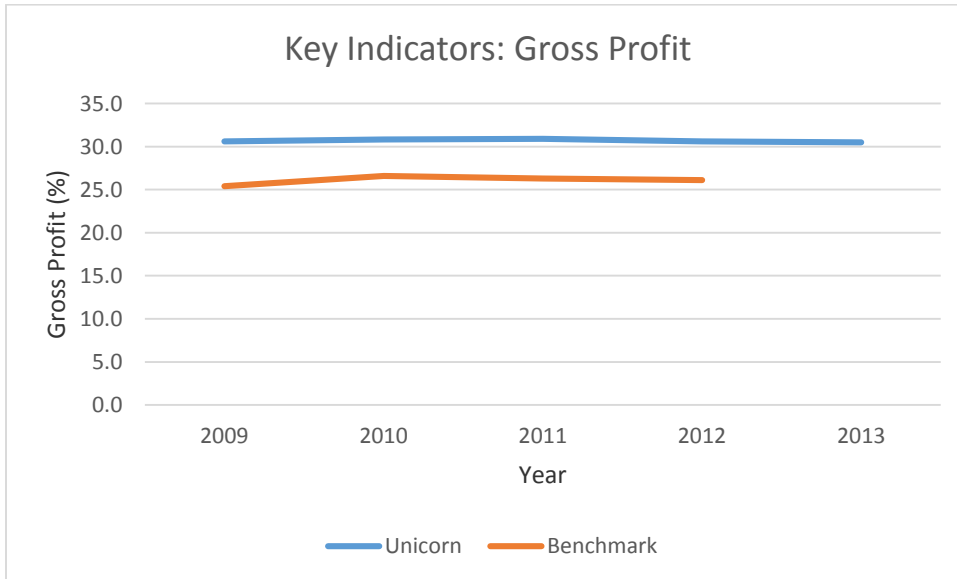
- Current Ratio (**Solvency**)
- Return on Assets (**Asset Efficiency**)
- Debt to Equity (**Strength**)

Gross Profit/Margin %

% of sales remaining after deducting costs relating to production and sale of goods:

$$= (\text{Gross Profit (£)} / \text{Sales}) * 100$$

$$\text{2012: } (1,391,921 / 4,542,785) * 100 = \text{30.6\%}$$



Comments:

- Unicorn has a consistently higher Gross Profit than the industry benchmark
- **BUT** do we include all the costs relating to purchasing stock and getting it on the shelves – there is a massive wage element not included in our Gross Profit?
- Gross Profit is also manually fixed at around 30.5% for quarterly accounts and the figure can only be verified at the end of the year when we do our physical stocktake

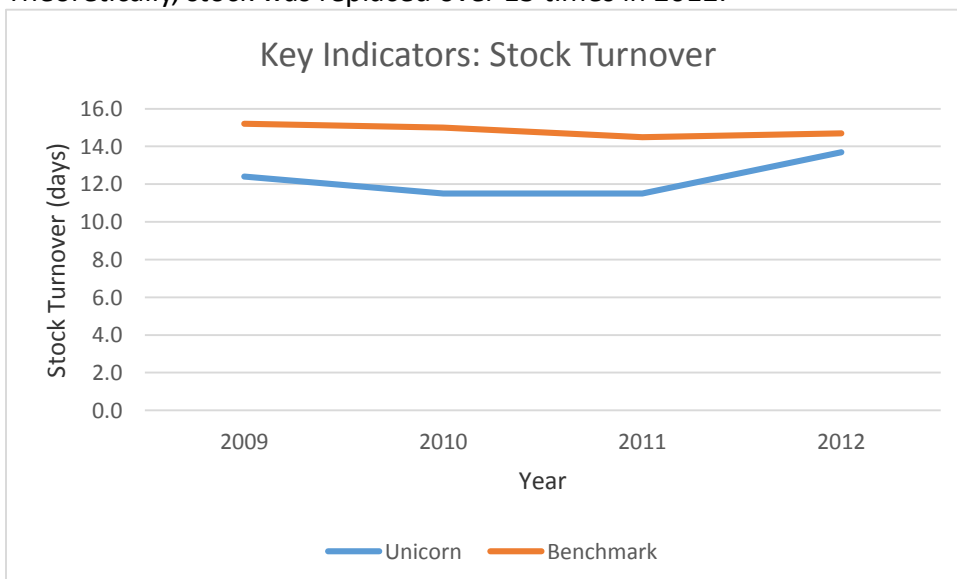
Stock Turnover

Stock turnover measures how often, at the current rate of sales (i.e. 12/6 month period), the entire stock is completely sold and replaced during a given year/period (higher is better):

= *Cost of Goods Sold (COGS) (purchases only) / Stock at Cost (taken from the annual stock take)*

2012: 3,087,449 / 230,057 = **13.42**

Theoretically, stock was replaced over 13 times in 2012.



Comments:

- Unicorn is consistently below the industry average. Why? Are we being as productive with our purchasing as we could be? Over ordering v minimising reordering costs and obtaining best prices from dealing direct
- There are massive variations in stock turnover between parts of the business (i.e. veg turnover is 3 days) so is this a useful ratio for us to use?
- We only know our actual stock figure at 31 December in any given year so is it possible to improve on this ratio without real time information?

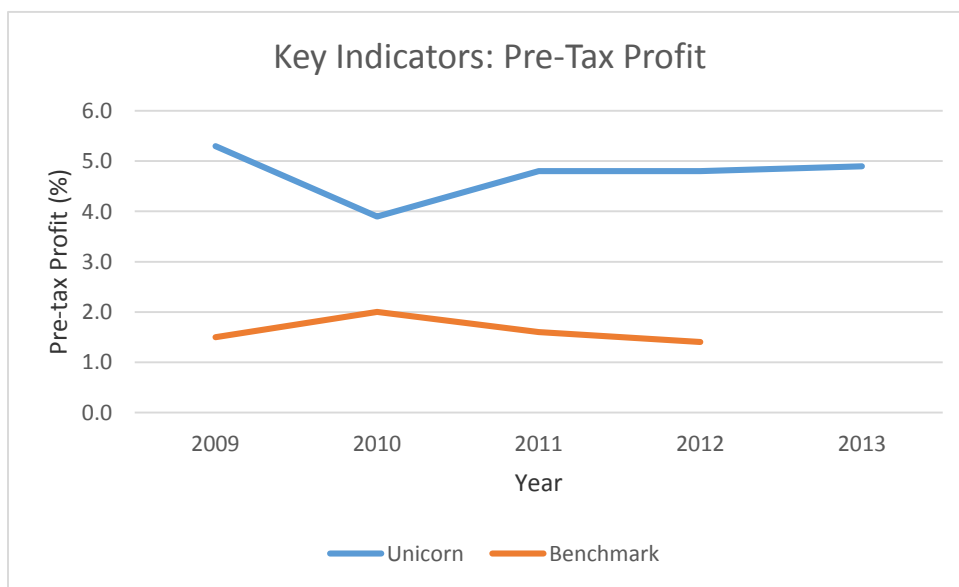
Pre-Tax Profit %

Pre-tax profit indicates the percentage of sales remaining after all costs (except taxes) are deducted (higher is better):

$$= (\text{Profit before Tax} / \text{Sales}) * 100$$

$$\text{2012: } (216,977 / 4,542,785) * 100 = \mathbf{4.78\%}$$

For every £1 of sales, 4.8 pence is left as profit before tax.



Comments:

- Unicorn is consistently above the industry average
- What other operating savings can we make to maximise profit?

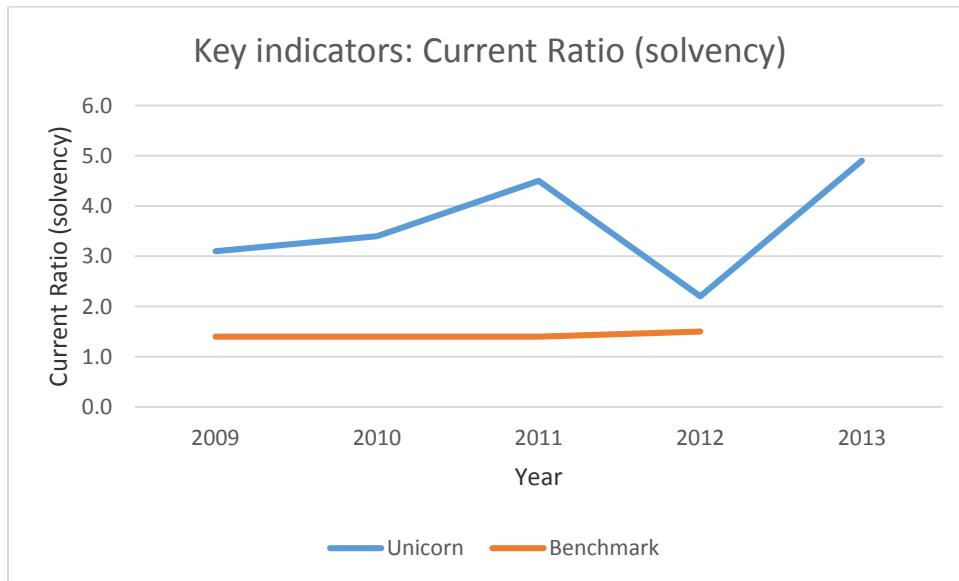
Current Ratio

The current ratio tests for our ability to meet our current obligations (i.e. supplier payments, bank loan etc.). It measures how well we can cover our current liabilities with our liquid assets (higher is better):

$$= \text{Current Assets} / \text{Current Liabilities}$$

$$\text{2012: } 939,264 / 429,577 = \mathbf{£2.19}$$

There is £2.19 of current assets available to cover every £1 of our debt (i.e. supplier payments etc.).



Comments:

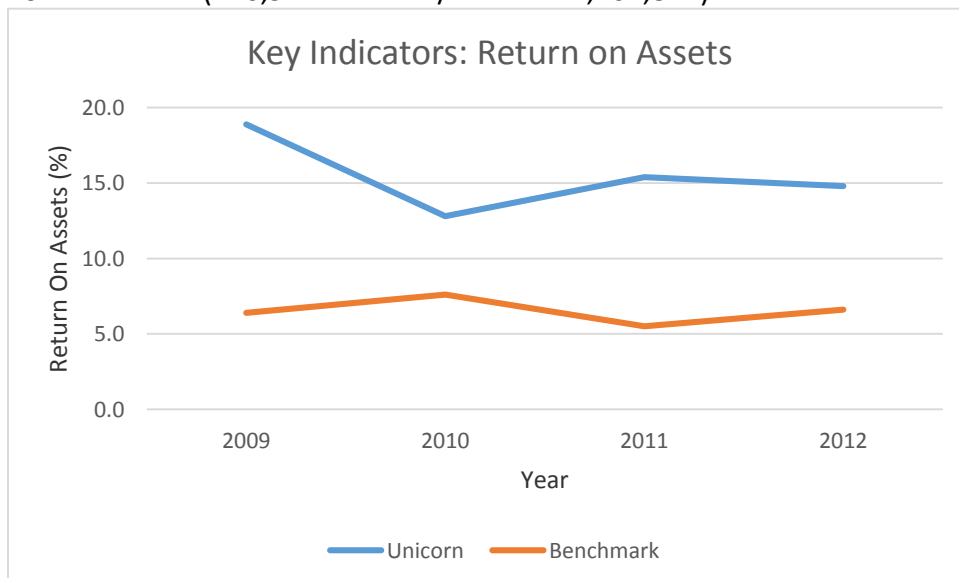
- Unicorn is consistently above the industry average and current figures indicate good financial strength
- The figure would be even better if we excluded the element of the Triodos loan due after more than one year
- A Quick Ratio (tests the degree of solvency more strictly by only using cash balances (i.e. 1.61)
- If the ratio falls below 1 it may indicate an issue with working capital management and cash flow
- Unicorn's current ratio may fall below 1 on completion of the building work and for a period thereafter whilst cash is replenished so the cash flow will have to be carefully monitored during this time

Return on Assets (%)

Return on Assets indicates how profitable Unicorn is relative to its assets; it measures how effectively we are converting our cash into net profit (higher is better as more money is being made on less investment):

$$= (\text{Profit before Tax} / \text{Net Assets}) * 100$$

2012: (216,977 / 1,464,821) * 100 = **14.8%**



Comments:

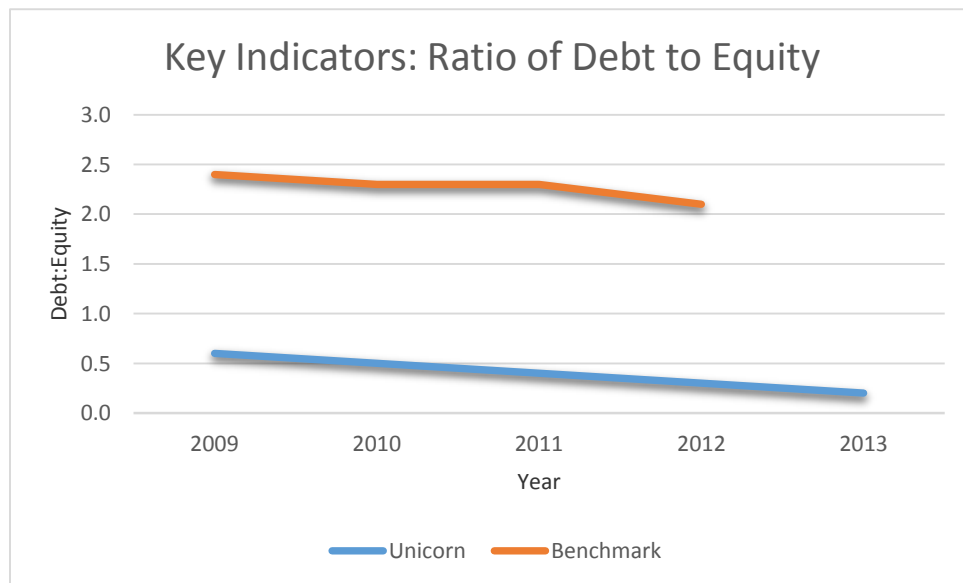
- Unicorn's Return on Assets is consistently more than double that of the industry average
- What up and coming spends may increase our Return on Assets?

Debt to Equity Ratio

The debt to equity ratio indicates what proportion of equity and debt the company is using to finance its assets (the lower the better).

= *Total Liabilities / Shareholders Funds*

2012: $(429,577 + 67,081) / 1,464,821 = 0.34$



Comments:

- Unicorn doesn't really do debt! Our recent growth has mainly been financed via reinvestment of surplus profits
- Loan Stock has been issued in the past specifically for the purchase of the building and the land
- Minimal debt avoids periods of volatile profits as a result of additional interest expense

UNICORN – SPECIFIC INDICATORS

Unicorn uses 5 main indicators to monitor the performance of the business on a weekly basis. The majority of the indicators are published either in the weekly newsletter or in the Finance minutes. This section of the pack will help you understand why these indicators are used within the business, how to calculate them, what do the results might mean and how that information is used to either improve ongoing performance or influence decisions on how to run the business in the future.

Average Basket

Every time a customer enters the shop we want to try and maximise what they buy thereby maximising sales without affecting gross profit. This will increase our profitability as, the more a customer buys in one trip, the more our fixed costs in relation to that visit will be reduced.



Average Weekly Basket = Weekly sales / Weekly customers

Average Basket to date = Sales to date / Customers to date

Examples:

Week ending 27/10/2013: 106,632 / 5790 = **£18.42**

2013 to date: 4,533,273 / 241,182 = **£18.80**

Sales per Hour (Sales Efficiency)

Sales per hour is a calculation we use to measure how efficiently we are working (i.e. for each hour worked what is the value of sales we generate). The higher the sales per hour figure the less we will be paying in wages in relation to sales, thereby increasing our net profit. Note that we include all paid hours (i.e. admin, holiday, sick etc.) in our calculation as opposed to shop floor hours worked.

Weekly Sales per Hour = Weekly sales / Weekly paid hours

Sales per Hour to date = Sales to date / Paid hours to date

Examples:

Week ending 27/10/2013: 106,632 / 1921 = **£55.51**

2013 to date: 4,533,273 / 79,039 = **£57.35**

We use sales per hour to determine the level of dividend we pay ourselves as members as we know that, all other things being equal, an increase in sales per hour for any given period will result in an increased profit for that period.

Our break-even (i.e. where net profit = £0) sales per hour on our current hourly rates (£10 & £8 per hour respectively with a 20% casual rate; where wage costs are 76% of operating expenses), based on a gross profit of 30.5% is approximately **£48.49**. The minimum sales per hour figure for a quarter that triggers payment of a dividend is currently **£52** per hour, with a maximum pay out when we hit **£54** per hour.

Paid hours as a proportion of sales (Wage Cost Forecasting & Control)

This is an inverse calculation of sales per hour. It is used to calculate wage costs for budgeting and cash flow forecasting, as at any given level of sales and hourly rate, we can calculate our minimum sales in order to break-even and forecast our wage costs based on predicted sales.

Our contracted probationary member and member hours are currently **1610.5** hours per week. We have to pay these wages regardless of what sales we make in the week. It is therefore useful to know what sales we need to generate to cover these and other fixed costs.

1610.5 hours at £10 per hour (* 1.17 for Employers NI and Pension) = £18,843

Currently wages costs are approximately 76% of operating costs so total operating costs = £24,793

To break even gross profit must = operating expenses = £24,793

Gross profit is on average 30.5% of sales, therefore sales must be at least **£81,289** per week

Conversely, paid hours as a proportion of sales must be $(1610.5 / 81,289) = \mathbf{0.0198}$ or lower in order to break-even at the current contracted hours and pay rate. Assuming the pay rate does not change we can use this figure to monitor wages costs on a weekly basis to ensure they do not exceed the break-even point (i.e. Sales * 0.0198 = the maximum number of hours we want to pay in a given week). This proportional break-even figure will increase slightly when we introduce the element of casual labour into our calculations as we pay this at 80% of our member rate.

Weekly paid hours as a proportion of weekly sales = Weekly paid hours / Weekly sales

Paid hours to date as a proportion of sales to date = Paid hours to date / Sales to date

Examples:

Week ending 27/10/2013: $1921 / 106,632 = \mathbf{0.0180}$

2013 to date: $79,039 / 4,533,273 = \mathbf{0.0174}$

Casual hours as a % of paid hours

Current policy states that the business will aim to have a casual rate of between 5-10% of total paid hours with 10% being a trigger for recruiting probationary members.

Weekly casual hours as a % of weekly paid hours = (Weekly casual hours / Weekly paid hours) * 100

Casual hours to date as a % of paid hours to date = (Casual hours to date / Paid hours to date) * 100

Examples:

Week ending 27/10/2013: (343 / 1921) * 100 = **17.9%**

2013 to date: (18,185 / 79,039) * 100 = **23.0%**



Increase/Decrease in cash balance

This figure is used to monitor cash flows in and out of the business on a fortnightly basis. It is a useful overall control to ensure the business is operating as predicted by the cash flow forecast (see above). With the forecast gross profit, paid hours as a proportion of sales, wage rates and fixed costs the business is predicted to generate about **£24k** operating surplus (or cash) per month in 2013, before any additional income or expenditure (i.e. packing machine).

Examples:

15.10.2013 – 31.10.2013: £615k - £597k = **Increase of £18k**

Year to date: £615k (Balance on 31.10.2013) - £730k (Balance on 10.01.2013) = **Decrease of £115k**

The fortnightly bank balance between the period 15.10.2013 and 31.10.2013 increased over and above the cash flow forecast. There were no additional payments in that period.

Over the year (2013) our bank balance has actually decreased by £115k. The estimated operating surplus of **£240k** (10 month period) in the cash flow forecast has been partially offset by the following additional non-operating expenditure over the same period:

	£
Fixed Assets:	
Computer Equipment	3,650
Premises Improvements	26,870
Plant & Machinery	13,144
Fixtures & Fittings	23,280
Other Debtors:	
Loan to Glebelands II	5,000
Prepayments:	
Insurance	12,500
Bank Loan Repayments	6,640
2013 Loanstock Repayments	239,215
Corporation Tax	50,150
Dividends	42,000
1% & 4% Donations	31,193
	<hr/>
	453,642

The above would suggest that the bank balance over the 10 month period should actually have decreased by **£214k** (i.e. £240k - £454k). Both this year to date figure and the fortnightly balance figures detailed above suggest that we are generating more operating cash than forecast (i.e. **£99k year to date**). This is mainly borne out by the following:

- Sales to date (2013) are **18.55%** higher than 2012; cash flow forecast only predicted a 10% increase. Additional GP less wage costs (10 months) = approximately **£43k** additional cash
- Paid hours to date (2013) are **0.0174** as a proportion of sales; cash flow forecast calculated at 0.019. Wage costs saved (10 months) approximately **£74k** additional cash

This general overview isn't an exact art (hence **£18k** unaccounted for), but it does show that we can quickly reconcile, up to a point, our cash flows in and out of the business during a given time period.

For an exact picture of how cash moves in and out of the business over a given period of time we have to produce a Cash Flow Statement.

Cash Flow Statement

As a small company we don't legally have to produce a Cash Flow Statement but it is a useful tool to how we, as a business generate and spend our cash over a given period (usually a financial year). It is used in conjunction with the Profit and Loss and Balance Sheet and reconciles the difference between **profit** and the increase/decrease in the **cash at bank** on the Balance Sheet. In other words the statement captures both the current operating results and the accompanying changes in the balance sheet. It also bridges the gap between one Balance Sheet and the next and reports on how our financial position has changed.

PROFIT ≠ CASH

As previously stated, the balance sheet is a snapshot of our assets and liabilities at a single point in time and the Profit and Loss Account summarises our financial performance over a period of time. These two financial statements reflect the 'matching' concept used to match sales with the expenses associated with generating that income.

The cash flow statement includes only inflows and outflows of **cash**; it excludes transactions that do not directly affect cash receipts and payments (e.g. depreciation).

The cash flow statement is intended to:

- provide information on our liquidity and solvency and our ability to change cash flows in future circumstances
- provide additional information for evaluating changes in assets, liabilities and equity
- improve the comparability of our business compared to a similar businesses operating performance by eliminating the effects of different accounting methods

The cash flow statement is divided into 3 sections:

1. cash flow resulting from operating activities; and
2. cash flow resulting from investing activities; and
3. cash flow resulting from financing activities.

The money coming into the business is called cash inflow, and the money going out of the business is called cash outflow.

Operating Cash Flows

Operating cash flows include:

- Receipts from the sale of goods or services
- Interest received on loans
- Payments to suppliers for goods and services
- Payments to employees or on behalf of employees
- Interest payments

For our purposes the only item that is added back as a non cash flow item is depreciation.

To calculate our operating cash flow we have to start with the profit before tax figure for the year. Depreciation is added back and then the adjustments are made for changes in the balance sheet items of stock, debtors and some creditors.

Let's look at our purchases, expenses and wage costs as a whole. The figure in the profit and loss account are the amounts incurred in generating the sales for the financial year (the matching principle). However, these figures do not take into account whether these amounts have been paid for or not. Sitting on the balance sheet at the end of each year is a figure for trade creditors, other taxes and accruals. These are amounts that have been included in the profit and loss account but not paid for. The difference between these balance sheet amounts at the start of the year and the end of the year is a cash adjustment to the net profit.

At the end of 2011 trade creditors, other taxes and accruals = $(68,269 + 4,782 + 26,004) = £99,055$. At the end of 2012 the figure was $(88,708 + 4,936 + 26,309) = £119,953$; a difference of **£20,898**. This represents an **increase** in purchases, expenses and taxes not paid for which means that the business has this additional cash in the bank until these items are paid for.

The same principle is applied to stock and debtors. An increase in the stock figure from the end of the 2011 to the end of 2012 means that more cash is tied up in stock, and until that stock is sold the cash won't become available to us again.

A summary of the reconciliation of profit before tax to cash for 2010-2012 is detailed below.

Unicorn Grocery Ltd

Profit Before Tax v Cash

	2012	2011	2010
Profit Before Tax	216,977	199,292	146,147
Depreciation	53,237	47,807	60,254
(Increase)/Decrease in Stock	18,219	(22,238)	(19,126)
(Increase)/Decrease in Debtors	(2,453)	1,020	(6,234)
Increase/(Decrease) in Creditors	20,898	(35,711)	18,768
Net Cash Inflow from Operating Activities	306,878	190,170	199,809

Investing Activities

Cash inflows from investing activities include:

- Receipts from the sale or disposal of land, property, plant or equipment
- Receipts from the sale of investment

Cash outflows from investing activities include:

- Payments to acquire land, property, plant or equipment
- Payments to acquire an investment

Financing Activities

Cash inflows from financing activities include:

- Receipts from issuing Member Shares
- Receipts from issuing loan stock or taking out a bank loan

Cash outflows from financing activities include:

- Repayment of loan stock and bank loans
- Payments to redeem Member Share

A summary of Investing and Financing cash inflows and outflows for 2010-2012 is detailed below.

Unicorn Grocery Ltd

Investing & Financing Activities

	2012	2011	2010
Investing Activities			
Cash to purchase fixed assets	(62,424)	(50,908)	(7,087)
Cash from sale of fixed assets	-	329	275
Cash to purchase investments	(1)	(32,507)	(417)
Cash from sale of investments	500	-	-
	<u>(61,925)</u>	<u>(83,086)</u>	<u>(7,229)</u>
Financing Activities:			
Issue of Share Capital	1	3	(4)
Repayment of Loan Stock	(934)	8,291	(3,580)
Repayment of Bank Loans	(14,677)	(6,338)	(90,871)
	<u>(15,610)</u>	<u>1,956</u>	<u>(94,455)</u>

All these amounts can then be added together to produce a cash flow statement that reconciles profit to the increase in cash during the financial year. During 2012 the cash at bank figure increased from £512,323 to £694,353; an increase of **£182,030**.

Unicorn Grocery Ltd

Cash Flow Statements

	2012	2011	2010
Operating Activities Before Tax	306,878	190,170	199,809
Taxation	(47,313)	(45,047)	(56,573)
Operating Activities	<u>259,565</u>	<u>145,123</u>	<u>143,236</u>
Investing Activities	(61,925)	(83,086)	(7,229)
Financing Activities	(15,610)	1,956	(94,455)
Increase in Cash	<u>182,030</u>	<u>63,993</u>	<u>41,552</u>

Conclusion

Financial management is a crucial aspect of any thriving business. Maximising profit and generating cash depends on solid financial decisions. To make good decisions, we need good information. As a member and director with financial responsibility, you have to be able to interpret this information yourself.

Financial statements contain important information about our operating results and financial position. The relationship between certain items of financial data can be used to identify areas where we excel and, more importantly, where there are opportunities for improvement. Using, understanding, and interpreting these statements collectively will help us make much better business decisions.

The basic financial statements are:

- Profit & Loss Account
- Balance Sheet
- Cash Flow Forecast
- Cash Flow Statement (not currently a legal requirement for our business)

While these statements look at different aspects of the company, they are interrelated and dependent on each other, as information from one is needed to prepare the others. The key to understanding accounts is to have a good grasp of what the basic statements are there to do: how they are prepared, what they tell you, and what they don't.

What a Profit & Loss Account tells you:

- It reports the main and any secondary sources of sales/income
- The items listed as expenses are expired, meaning they have no useful value left (i.e. they have been spent)
- $\text{Sales} - (\text{Costs} + \text{Expenses}) + \text{Other income} - \text{Other expenses} - \text{Tax} = \text{Net Profit}$

What a Profit & Loss Account does not tell you:

- It does not predict the future
- Net profit \neq cash!

What a Balance Sheet says:

- It gives a detailed summary of the assets and claims against those assets, as at a particular date
- It provides information about our financial position with regard to our ability to pay current debts
- It gives us a view of our financial position to carry on our business (i.e. the fixed asset section indicates the value of the resources we have working for us to assist in generating sales)

What a Balance Sheet does not say:

- The 'Profit & loss account' in Capital & Reserves = cash (i.e. at the end of 2012 we had £1.465m in reserves but only £694k in cash)
- It does not report the market value, current value, or worth of our business

The big difference between a profit and loss statement and balance sheet is that the profit and loss statement winds back to zero at the end of each financial year, recording sales, costs and expenses for a fixed period of time only.

The balance sheet, however is a cumulative record of what's happened in our business right from the start.

'Cash is King'

Understanding the cash flow forecast is the key to running a successful small business such as Unicorn. Good cash flow management helps us to ensure our business runs smoothly and gives us the insight to make informed decisions.

- Are we meeting our expectations (i.e. under/over performing) when comparing actual to forecast? What are our over spends? Are we over forecasting wage costs?
- It can help predict upcoming cash surplus (look at investment strategies) or shortages (do we need an overdraft facility).
- It can forecast the cost/benefit of a business change or decision (i.e. increase in membership)
- It allows us to incorporate best, worst and most likely case scenarios

Cash Flow Statement

The cash flow statement reports how our activities affected cash during a financial year and reports the sources and use of that cash.

What a Cash Flow Statement says:

- Is the business generating enough cash from normal operations to continue operating
- Will the business generate sufficient cash for future investment/expansion
- Is the business generating sufficient costs to pay Interest on Members Shares
- To what extent is the business investing in new plant & equipment needed for future operations

What a Cash Flow Statement does not say:

- The profit the business has generated
- The financial condition of the business at the end of the year

To Reiterate

There is a substantial amount of information in this pack to digest. It will take time to review and understand and just for good measure things will change! However, once you have grasped a basic understanding of the principles behind the numbers and how the information interrelates the overall picture might become a little clearer!