

# Business Analysis v 1.0

## A Primer

To be used in conjunction with Corporate Profitability

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## Introduction

In the simulation, you would need to make decisions on investing in equipment, renting warehouses, purchasing inventory as well as on hiring consultants. Apart from that, you would need to make decisions on how much to spend on advertising, training and customer service besides incurring other costs like rent, admin, salaries etc.

## The Financial Statements – A review

From an accounting perspective, you have recorded your sales (revenues) and computed your profits in the *Profit & Loss Statement*.

Cash moves in and out of the business. Its timing is dependent on when you receive payments from your customers (debtors/receivables) or when you pay your suppliers (creditors/payables) for stocks (inventory). In addition cash moves out of the business when equipment is purchased as well as for other expenses like staff recruitment, promotions, rent, staff wages, administration, bank interest, taxes and dividends.

At any time, you will know how much cash is in the business or where it is ‘stuck’ from the *Balance Sheet*.

In the simulation, money (cash) needed to buy equipment\* is obtained through the following means

- Existing Cash in the business. (As recorded in the *Balance Sheet*)
- Loan from the bank
- From Shareholders who would need a further stake in your business via additional Share Capital.

*\* In real life, there is a possible option to lease the equipment instead of buying the equipment outright as some airlines do with their aircraft.*

## The P&L Statement

As a manager responsible for a business unit, you might receive the *P&L Statement* on a monthly basis. The following may be a typical *P&L Statement* for a Dealership.

	May-16
Sales (Revenues)	8,000,000
Cost of Sales	7,624,000
<b>Gross Profit (GP)</b>	<b>376,000</b>
Recruitment	80,000
Rent	70,000
Wages	180,000
Promotion	150,000
Admin	80,000
<b>Total Expenses</b>	<b>560,000</b>
<b>EBITDA</b>	<b>(184,000)</b>
Depreciation	60,000
<b>EBIT</b>	<b>(244,000)</b>
Interest	80,000
<b>Profit Before Tax (PBT)</b>	<b>(324,000)</b>
Tax (30%)	(97,200)
<b>Profit After Tax (PAT or Net Profit)</b>	<b>(226,800)</b>

*Figure 1. The P&L Statement*

### **An analysis of the P&L Statement**

The *P&L Statement* in Figure 1 states that for the month of May 2016, the company has made revenues or sales of \$8,000,000 with a loss after tax or net loss of \$7,000. The losses could be contributed by many factors namely,

- a. Low or Discounted Selling Price
- b. High Cost of Sales (high purchasing cost for stocks)
- c. High Fixed Expenses

To analyse the problem further, there has to be a point of reference. References that can be used to gauge whether the financial results for March 2016 is acceptable include

- a. Budget or Annual Management Plan
- b. Actual numbers and ratios from previous months
- c. Industry Benchmark Ratios

## Benchmarks

Refer to the much more comprehensive *P&L Statement* on in Figure 2.

- A. Break down the *P&L Statement* to as many revenue, COS and Expenses components as possible.
- B. Populate the spreadsheet with numbers from previous months. Go as far back as possible. It is important to look out for trends.
- C. Compare the May 2016 results with the previous month (April 2016) or even with the same period in previous years. (May 2015 or May 2014).
- D. Look at the ratios by constructing a common size *P&L Statement*. A common size *P&L Statement* expresses all *P&L Statement* items as a Percentage of Sales. Look at the trends from previous months.

In the case of D1, the Gross Profit % for May 2016 is 4.7% vs a year ago of 5.9% - a 1.2 percentage points reduction. Why ?

D2 and D3 shows that the 'Wages %' and 'Promotions %' have increased. Why ?

These have contributed to a lower EBITDA % and Net Profit % as shown in E1 and E2.

A common size *Balance Sheet* expresses all *Balance Sheet* items as a percentage of total *Assets*.

	May-15	Apr-16	May-16
Sales (Revenues)	7,750,000	7,850,000	8,000,000
Cost of Sales	7,290,000	7,437,000	7,624,000
Gross Profit (GP)	460,000	413,000	376,000
<i>Gross Profit % (GP %)</i>	<i>5.9%</i>	<i>5.3%</i>	<i>4.7%</i>
Recruitment	80,000	80,000	80,000
Rent	50,000	50,000	70,000
Wages	150,000	160,000	180,000
<i>Wages %</i>	<i>1.9%</i>	<i>2.0%</i>	<i>2.3%</i>
Promotion	120,000	150,000	150,000
<i>Promotion %</i>	<i>1.5%</i>	<i>1.9%</i>	<i>1.9%</i>
Admin	80,000	60,000	80,000
Total Expenses	480,000	500,000	560,000
EBITDA	(20,000)	(87,000)	(184,000)
<i>EBITDA %</i>	<i>-0.3%</i>	<i>-1.1%</i>	<i>-2.3%</i>
Depreciation	60,000	60,000	60,000
EBIT	(80,000)	(147,000)	(244,000)
Interest	80,000	80,000	80,000
Profit Before Tax (PBT)	(160,000)	(227,000)	(324,000)
Tax (30%)	(48,000)	(68,100)	(97,200)
Profit After Tax (PAT or Net Profit)	(112,000)	(158,900)	(226,800)
<i>PAT %</i>	<i>-1.4%</i>	<i>-2.0%</i>	<i>-2.8%</i>

Figure 2. Analysing the P&L Statement

## Summary

The analysis will give you clearer picture on where the challenges of the organisation lies and what steps can be taken to move the financials in the right direction. There is no one single way to analyse the numbers.

What is more important is that the finance, sales and operational teams should get together at least on a monthly basis to discuss areas for improvement, exchange ideas, decide on whether additional data is needed and to set action plans.

It is wise to start with a few small initiatives to get quick but lasting results. Celebrate the results with the team. This will set the stage for larger initiatives across the organisation.



## Appendix

Gross Margin = Gross Profit / Sales

*Shows the basic profitability of a product or service, before any fixed costs are added in.*

Operating Margin = Operating Profit (EBIT) / Sales

*Indicates how well a company is running its entire business from an operational point*

Net Profit Margin = Profit After Tax / Sales

*Tells a company how much profit it has made for every sales dollar after everything else has been paid for ie. Recruitment, Rent, Promotions, Wages, Admin, Taxes, Interests etc.*

Return on Assets (ROA) = Profit After Tax / Total Assets

*Tells you what percentage of every dollar invested in the business was returned as profit. An ROA that is higher than the industry average may suggest that the company isn't renewing its assets (eg. Machinery and Equipment) for the future*

Return on Equity (ROE) = Profit After Tax / Shareholder's Equity

*Tells you what percentage of every dollar of equity invested in the business was returned as profit.*

Debt-to-Equity Ratio = Total Liabilities / Shareholder's Equity

*It tells how much debt the company has for every dollar of shareholder's equity.*

Current Ratio = Current Assets / Current Liabilities

*Current Assets are those that can be converted into cash fast. Current Liabilities are those that will have to be paid off in less than a year which includes creditors (payables) or short term loans and overdrafts. If the current ratio is less than 1, there is always a danger of running out of cash in the near term unless you can find a way of generating cash or attracting more investors.*

**End**