The ABCs of Financial Performance Measures and Benchmarks for Canada's Tourism Sector

Linking Your Financial Performance Measures to Your Business Plan

Guide 5

Discover our true nature

Canadian Tourism Commission

Commission canadienne du tourisme

Canada

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for the
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Scott Meis
Executive Director, Research

Preface

The tourism sector has recently experienced a slower growth in sales activities due to the slowdown in economic activities, the September 11, 2001 tragedy, the Iraqi War and most recently the outbreak of Severe Acute Respiratory Syndrome (SARS). Whether this slower growth pace will continue over the next years is still a question mark. However, one thing is certain; to stay competitive and increase profitability, tourism operators will have to be more vigilant in managing their business establishments.

We are pleased to make available *The ABCs of Financial Performance Measures and Benchmarks for Canada's Tourism Sector* Guides. There are six guides in the series:

- Guide 1 – Financial Planning: Key to Maximizing Your Bottom Line
- Guide 2 – Profiling Your Financial Statements
- Guide 3 – Financial Performance Measures and Benchmarks for Canada's Tourism Operators
- Guide 4 – Decision-making Tools for Canada's Tourism Operators
- Guide 5 – Linking Your Financial Performance Measures to Your Business Plan
- Guide 6 – Industry Financial Averages and Benchmarks for Canada's Tourism Operators.

These six financial planning guides were written for tourism operators who have little or no experience in the area of finance. These guides can be used as reference documents by tourism operators who wish to better understand the language of accounting and finance, maximize the utilization of the financial planning spreadsheet, and discuss with more self-assurance their financial plans with investors. These guides become progressively more sophisticated, ranging from the principles of finance and culminating with cutting edge performance measures and financial analysis and decision-making techniques.

In addition, to help tourism operators in improving the analysis of their business establishment and the effectiveness of their decisions, we will also be introducing a new tool; a customized tourism operators' financial planning spreadsheet in the near future. This practical and user-friendly tool can help tourism operators analyze quickly the impact of their decisions on the financial destiny of their business establishments. After taking just a few moments to input their financial statement data on the spreadsheet, tourism operators will be able to view the financial profile of their businesses from different angles: liquidity, profitability, productivity, overall financial health, growth rate, financial stability and shareholder value. The financial planning spreadsheet will not only calculate the more critical financial performance measures of their business, but will also compare them to industry averages and financial benchmarks. This way, tourism operators will be able to determine how well they are doing and what needs to be done to improve their performance in order to remain profitable and competitive. This spreadsheet also offers tourism operators several decision tools that will help better assess the viability of their investment decisions.

These six guides and the financial planning spreadsheets will be made available on the CTC's website: www.canadatourism.com

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Introduction

Most tourism operators formulate objectives and prepare detailed plans informally, rarely sharing them with others. This Guide is designed to change this behaviour and advises operators to formalize the process of setting objectives and plans. It encourages everyone in a business to participate in the preparation, execution and tracking of goals and objectives.

To have a meaningful plan, objectives should be quantified wherever possible. The exact number of employees working in each section of a business should be tracked, for example, as well as the costs associated with hiring and supporting them. Of equal importance, each employee's contribution to sales and profits should be pinned down and compared with these costs. Advertising cost should also be quantified and analyzed.

The chief advantage of a formal planning process lies in the ease of tracking and interpreting results. Many businesses compare proposed budgets to actual results, but few assess how operational decisions impact financial performance – an analysis that yields critically important information.

Once strategic and operational plans have been documented, they should be translated into dollars and cents in budgets and pro-forma financial statements for the following year or two. Most tourism operators are familiar with budgets – often the only formal plans their companies prepare. Most operators are not as familiar with pro-forma financial statements (balance sheets, income statements and statements of cash flows). These financial statements are critical because they give a complete picture of the impact of management decisions on future financial health.

In simple terms, budgets and pro-forma financial statements articulate operational objectives in financial terms. For example, if a tourism operator offers four different products or services in five different locations, sales estimates should be prepared for each product, service and market. The sum of these figures provides the estimated sales figure, entered in the corporate budget and pro-forma income statement. This process can be also applied to each cost listed on an income statement. For example, it is important to estimate how many employees it will take to provide a particular service, along with how much material and overhead, and what each will cost. The scope of these "planning assumptions" can vary to include as much or as little detail as desired. Once all revenue and cost items are combined, the operator can estimate how much profit the company will earn in the upcoming budget year.

This process can be extended to developing planning assumptions and applying them to all revenue, expense, asset, liability and equity accounts presented on income statements and a balance sheets. This type of estimate projects how much cash will flow into and out of the business. The outcome of this process is expressed in projected – or pro-forma financial statements, including the:

1. Income statement
2. Statement of retained earnings
3. Balance sheet
4. Statement of cash flows.

The information or assumptions used to formulate these pro-forma financial statements should be an essential part of a business plan. The basic structure of a business plan includes:

1. Table of contents
2. Executive summary
3. Company summary
4. Company management
5. Marketing proposal
6. Financing proposal
7. Operational data
8. Environmental statement
9. Conclusion
10. Appendices

Rather than describe how to prepare a business plan, this Guide explains some of the typical planning assumptions (or questions) that a tourism operator focuses on in order to estimate, as precisely as possible, the revenue, expense, asset, liability and equity items presented on financial statements.

Appendices 2.1 through 2.4 present four financial statements of a fictional company – TravelWorld Inc. Each statement contains columns for three successive years: actual 2000, projected year-end 2001, and 2002 – the objective, or budget year. The purpose of this Guide is to list the questions that a business operator should consider to accurately forecast all the items listed on the four financial statements.

Income Statement Planning Assumptions

Appendix 2.1 shows TravelWorld Inc.'s income statement for three years. As shown, the objective for net sales revenue is $27,965,000 – an increase of 11.5 percent over 2001. Once all operating expenses are deducted from this revenue, the TravelWorld Inc. will realize a $3,162,000 profit objective. To prepare a comprehensive business plan, TravelWorld Inc.'s operators should formulate and document financial targets for each line shown in Appendix 2.1, and more importantly, clearly pinpoint the assumptions used to realize the revenue and cost estimates.

This Guide gives examples of typical questions that can help in the formulation of financial planning assumptions. Each line on TravelWorld Inc.'s income statement shows a financial objective (or target), the increment over the previous year's (2001) operations and the percentage related to the revenue line. For example, the objective for total cost of goods sold is $14,464,000. This represents an 11.1 percent increase over the previous year ($14,464,000 - $13,017,000) ÷ $13,017,000). Also, total cost of goods sold accounts for 51.7 percent of net sales revenue ($14,464,000 ÷ $27,965,000).

Net Sales Revenue Planning Assumptions

	Objective	% Increase
Net Sales Revenue	$27,965,000	11.5

Net sales revenue represents products/services sold by TravelWorld Inc. Essentially, it is the number of units sold or customers served multiplied by the unit-selling price (the unit selling price should incorporate an inflation rate). An analysis should focus on the following questions.

- By how much will the market expand?
- How will the business fit within the industry?
- Who are the business' key competitors?
- What makes the product/service unique?
- What is the customer profile (give the details of the typical customers that will want to be served by the business)?
- What will be the share of market?
- How many products will be sold?
- How many customers will be served?
- Will there be changes in the selling price?
- What amount of inflation will be included in the selling price?
- Will new service/product lines be introduced?
- Will the existing service/product lines be modified?
- Will the business push its products/services in new geographic regions?
- Will the business' service/product mix change?

Cost of Goods Sold Planning Assumptions

	Objective	% Increase
Cost of Goods Sold	$14,464,000	11.1
Percent of Revenue		51.7

Cost of goods sold relates to all activities related to producing a good or providing a service, such as the purchase of raw materials, the cost of transporting goods (freight-in), and all costs associated with manufacturing (e.g., wages, depreciation of the machinery and equipment, supervisors' salaries, insurance, etc.). In a service organization, management includes costs incurred for providing services to customers. Salaries usually represent the largest portion of cost of goods sold in a service organization.

On TravelWorld Inc.'s income statement, cost of goods sold increased slightly less than the revenue increment (11.1 percent versus 11.5 percent). As shown in Appendix 3.5, cost of goods sold – as a percentage of net sales revenue – shows an efficiency improvement (from 51.9 percent down to 51.7 percent). The more significant cost of goods sold accounts includes purchases, freight in, salaries, depreciation and other charges.

Purchases include all goods required to make products or provide services. TravelWorld Inc.'s statement shows a 5.6 percent increase over 2001; expressed as a percent of net sales revenue, the amount is projected to fall from 26.8 to 25.4 percent. An analysis of this cost item should focus on the following questions:

	Objective	% Increase
Purchases	$7,104,000	5.6
Percent of Revenue		25.4

- Will the business change suppliers?
- Who are the firm's most important suppliers and where are they located?
- What type and quantity of supplies are purchased from each?
- What terms or purchase agreements does the firm have with existing suppliers?
- Will there be a change in the product mix?

- What is the strategy for ordering goods and supplies from suppliers?
- What discounts apply (e.g., quantity, trade, etc.)?

Freight in includes all costs associated with transporting goods from suppliers to TravelWorld Inc. business. It shows a 38.1 percent increase from the previous year and a drop in efficiency. For every dollar's worth of net sales revenue, 0.010 cents (versus 0.008 cents for the previous year) will be spent on freight in. An analysis of this cost item should focus on the following points.

	Objective	% Increase
Freight in	$290,000	38.1
Percent of Revenue		1.0

- Will the company be using different distribution networks? If so, what are they?
- Will the distribution network help get the goods to the plant faster?
- Will there be an increase in the freight prices? How much?
- Does a change in the mix of suppliers affect the freight in costs?

Salaries include wages, salaries, bonuses, overtime and benefits. This cost relates to all personnel producing the goods or providing the services that comprise the chief activity of the business. This item shows a 7.9 percent increase over the previous year and describes an efficiency improvement-expressed as a percentage of net sales revenue, salaries account for 18.4 versus 19.0 percent. An analysis of this cost item should focus on the following points.

	Objective	% Increase
Salaries	$5,140	7.9
Percent of Revenue		18.4

- How many workers will be employed to provide the service and make the product?
- What is the make-up of the production or service organization (organizational chart)?
- What is the make-up of the labor force?
- How many more (or less) workers will be required in the plant?
- What competencies or skills will be needed?
- Will there be a new union agreement (if a union exists)? If so, what are the broad conditions?
- Will the business offer new compensation benefits to the workers?
- How efficient is the labor force?
- What is the employee turnover rate?

This account includes depreciation for all equipment, vehicles and machinery used to produce goods or provide services. It shows a 47.7 percent increase over the previous year. Expressed as a percentage of net sales revenue, it will increase to 6.8 percent from 5.1. An analysis of this cost item should focus on the following questions:

	Objective	% Increase
Depreciation	$1,890,000	7.7
Percent of Revenue		6.8

- Will new capital assets be purchased? If so, what are they and what is their value?
- What is the composition of the new capital assets?
- How does the new capital assets affect the increase in the depreciation?
- Will there be a change in the depreciation rate for different assets?
- Will some assets be sold? If so, what are they and how much they be sold for?

Other charges include all other expenses (overhead) incurred to produce goods and deliver services. It shows a 25.0 percent increase over the previous year. Expressed as a percentage of net sales revenue, other charges remain unchanged at 0.1 percent. Other charges can include the following:

	Objective	% Increase
Other charges	$40,000	25.0
Percent of Revenue		0.1

- training and development
- insurance
- inspections
- quality controls
- maintenance and repairs
- supplies
- telephone and utilities
- travel and entertainment
- management fees
- postage

After paying the cost of goods sold, the company is left with a gross margin of $13,501,000. This amount is required to pay all other expenses incurred for sales and administration. As shown in the income statement, gross margin shows an increase slightly higher than the revenue increment (11.9 versus 11.5 percent). As a result, gross margin, expressed as a percentage of net sales revenue, shows an improvement from 48.1 to 48.3 percent. This improvement does not seem sizeable. However, had TravelWord Inc. achieved the same levels of efficiencies in cost of goods sold as it had in 2001, the company would have generated $13,451,000 ($27,965,000 X 0.481) in gross income – that is, $50,000 less in gross margin ($13,501,000 - 13,451,000). Gross margin is critical because it is the amount remaining (after paying cost of goods sold) for all remaining expenses (selling, administration, interest charges, extraordinary expenses and taxes) and for profit.

	Objective	% Increase
Gross Margin	$13,501,000	11.9
Percent of Revenue		48.3

Selling Expenses Planning Assumptions

Selling expenses includes all costs associated with marketing and distribution (freight out), such as sales salaries, commissions, travelling, advertising, depreciation and other charges. As shown in TravelWorld Inc.'s income statement, selling expenses increased slightly less than the revenue increment (10.6 versus 11.5 percent). As a result, selling expenses, expressed as a percentage of net sales revenue, improves from 17.5 to 17.4 percent.

	Objective	% Increase
Selling Expenses	$4,864,000	10.6
Percent of Revenue		17.4

Sales salaries include salaries, bonuses, overtime, benefits, etc. paid to all employees working in the sales organization (e.g., sales representatives, supervisors, managers). This item shows a 10.2 percent increase over the previous year and reveals an efficiency improvement. Expressed as a percentage of net sales revenue, sales salaries account for 15.4 versus 15.6 percent for the previous year. An analysis of this item should focus on the following questions:

	Objective	% Increase
Sales salaries	$4,304,000	10.2
Percent of Revenue		15.4

- How many employees will work in the marketing organization?
- What is the make-up of the marketing organization?
- How many sales offices are there and where are they located?
- What is the profile of a typical sales representative?
- How many sales representatives will be required in the marketing organization?
- What competencies or skills will be needed?
- Will the business offer new compensation packages to sales staff?
- How efficient are the employees working in marketing? What average sales revenue is expected from each representative and from each person working in marketing?
- What is the employee turnover rate?

Sales commissions shows a 15.4 percent increase over the previous year. Expressed as a percentage of net sales revenue, sales commissions accounts for 0.5 percent. An analysis of this cost item should focus on the following questions:

	Objective	% Increase
Commissions	$150,000	15.4
Percent of Revenue		0.5

- What is the structure of the sales commission package?
- Are sales commissions based on an individual or a group packages?
- How does the firm's sales commissions package compare to packages offered elsewhere in the industry?

Travelling expense shows a 12.5 percent increase over the previous year. Expressed as a percentage of net sales revenue, travelling accounts for 0.2 percent, unchanged from the previous year. An analysis of this cost item should focus on the following questions:

	Objective	% Increase
Traveling	$45,000	12.5
Percent of Revenue		0.2

- What is the nature of the firm's travelling and entertainment programs?
- What are the broad policies of the travelling and entertainment programs?
- How many conventions and meetings are included?
- What are the nature and objectives of the conventions?

Advertising shows a 17.0 percent increase over the previous year. Expressed as a percentage of net sales revenue, sales commission accounts for 0.2 percent, unchanged from the previous year. An analysis of this cost item should focus on the following questions.

	Objective	% Increase
Advertising	$55,000	17.0
Percent of Revenue		0.2

- What is the nature of the firm's advertising programs?
- What products or services will be advertised?
- What advertising media will the company use?
- What are the more important promotional programs?

This account includes **depreciation** of all equipment and vehicles used in marketing, such as cars, computers and office equipment. It shows a 12.0 percent increase over the previous year; expressed as a percentage of net sales revenue, depreciation remains at one percent. An analysis of this cost item should focus on the following questions:

	Objective	% Increase
Depreciation	$280,000	12.0
Percent of Revenue		1.0

- How much will be spent to purchase new capital assets?
- What is the composition of the new capital assets?
- How does the composition of the new capital assets affect the increase in the depreciation?
- Is there a change in the depreciation rate?
- Will some assets be sold? If so, what are they and how much they be sold for?

Other charges include all other expenses incurred to sell goods and services. It shows a 20.0 percent increase over the previous year. Expressed as a percentage of net sales revenue, other charges remains unchanged at 0.1 percent. Other charges can include:

	Objective	% Increase
Other charges	$30,000	20.0
Percent of Revenue		0.1

- training and development
- insurance premiums
- maintenance and repairs
- office supplies
- telephone and utilities
- management fees
- postage

Administrative Expenses Planning Assumptions

Administrative expenses includes all overhead expenses incurred by departments such as human resources, accounting, legal, research and development, finance and treasury. The largest administrative expense accounts include salaries, leasing, depreciation and other charges. Total administrative expenses increased more than the revenue increment. As a result, administrative expenses, expressed as a percentage of net sales revenue, rose from 10.1 to 10.3 percent.

	Objective	% Increase
Administrative Expenses	$2,875,000	13.2
Percent of Revenue		10.3

The **salaries** account includes office salaries, bonuses, overtime and benefits for all administrative employees. Salaries show a 13.5 percent increase over the previous year. Expressed as a percentage of net sales revenue, salaries will account for 7.5 percent compared to 7.4 for the previous year. An analysis of this item should focus on the following questions:

	Objective	% Increase
Salaries	$2,100,000	13.5
Percent of Revenue		7.5

- How many employees will be working in support or overhead organizations?
- What is the composition of these organizations?
- How many employees will be required in these support organizations?
- What competencies or skills will be needed?
- Will the business offer new compensation packages to these employees?
- What is the employee turnover rate in these support organizations?

Leasing includes the cost of all machinery and equipment rented for administrative purposes. Leasing shows a 7.7 percent increase over the previous year. Expressed as a percentage of net sales revenue, leasing remains unchanged at 0.5 percent. An analysis should focus on the following questions:

	Objective	% Increase
Leasing	$140,000	7.7
Percent of Revenue		0.5

- What equipment will be leased?
- What are the leasing agreements?
- Why are they being leased instead of being purchased?

The **depreciation** account relates to all equipment, such as computers, used in administration. It shows a 13.2 percent increase over the previous year; expressed as a percentage of net sales revenue, depreciation will remain at 2.1 percent. An analysis of this cost item should focus on the following questions:

	Objective	% Increase
Depreciation	$600,000	13.2
Percent of Revenue		2.1

- What is the value of all new assets to be purchased, such as computers, printers, fax machines, office furniture?
- What is the composition of the new capital assets?
- How does the composition of the new capital assets affect depreciation?
- Is there a change in the depreciation rates?

The **other charges** account includes all other expenses incurred by administration. It shows a 16.7 percent increase over the previous year. Expressed as a percentage of net sales revenue, other charges will remain unchanged at 0.1 percent. Other charges could include the following:

	Objective	% Increase
Other charges	$35,000	16.7
Percent of Revenue		0.1

- training and development
- insurance
- office supplies
- telephone and utilities
- management fees
- postage

Operating income is the profit that will be generated from operations; managers of TravelWorld Inc. are most responsible for this level of profit. TravelWorld Inc. is left with $5,762,000 to pay for other expenses such as interest, extraordinary charges and income taxes. As shown in the income statement, operating income shows a 12.3 percent increase. The company's operating income, expressed as a percentage of revenue, will improve to 20.6 from 20.4.

	Objective	% Increase
Operating Income	$5,762,000	12.3
Percent of Revenue		20.6

Interest income includes all income generated from short-term deposits and long-term investments. It shows an increase of 36.4 percent. An analysis should focus on:

	Objective	% Increase
Interest Income	$15,000	36.4
Percent of Revenue		0.1

- What types of investments will the company make?
- What amounts will be invested by the business?
- What returns will be generated from each investment ?

Interest charges include all interest charges that TravelWorld Inc. will pay on short and long-term loans. As shown, interest charges will decrease by $50,000 to $900,000 – a drop of 5.3 percent. Expressed as a percentage of net sales revenue, interest charges will decline from 3.8 to 3.2 percent. An analysis of this item should focus on the following questions:

	Objective	% Decrease
Interest Charges	$900,000	-5.3
Percent of Revenue		3.2

- Who are the firm's short and long-term lenders?
- How much is each lender owed?
- What cost and what percentage of total debt is owed to each source?

Extraordinary charges include all other non-operating charges (offset by other extraordinary income) to be incurred by the business, including:

	Objective	% Increase
Extraordinary charges	$15,000	50.0
Percent of Revenue		0.1

- write-down of capital assets.
- write-down of working capital assets (e.g., inventory, accounts receivable).
- downsizing costs
- income (or loss) earned due to the fluctuation of the Canadian dollar

Statement of Retained Earnings Planning Assumptions

Appendix 2.2 shows TravelWorld Inc.'s statement of retained earnings. The opening amount of retained earnings – drawn from the previous year's balance sheet – is $13,277,000. For the current year, $3,162,000 will be added, for a cumulative total of $16,439,000. From this amount, TravelWorld Inc. will pay $200,000 in dividends, bringing the retained earnings at the end of the year to $16,239,000. An analysis of this cost item should focus on the following questions:

- What are the terms for paying dividends?
- How many shareholders will receive dividends?
- How many preferred and common shareholders are there?

Balance Sheet Planning Assumptions

Appendix 2.3 shows TravelWorld Inc.'s balance sheet for three periods. The balance sheet focuses on three major categories of accounts: assets, liabilities and equity.

Assets

Asset accounts are broken down into three categories: current, capital and intangible. For each account shown in the balance sheet, TravelWorld Inc.'s operators will have to formulate and document an estimate, and explain how each estimate was calculated. As shown, total assets will be $29,810,000, an increase of 9.2 percent over the previous year. The following hypothetical comments and assumptions are used for illustration purposes only.

Current Assets Planning Assumptions

The objective of managing **current assets** (which are part of working capital accounts) is to accelerate the movement of cash into the business. This is referred to as the cash conversion cycle. The faster accounts receivable are collected and inventory is turned into cash, the quicker the business turns a profit. The most important current asset accounts are cash, marketable securities, prepaid expenses, accounts receivable and inventory. As shown, current assets will increase by 18.3 percent over the previous year; expressed as a percentage of total assets, they will amount to 10.3 compared to 9.6 percent for the previous year. Current assets will increase faster than net sales revenue (11.5 percent), which means that TravelWorld Inc. will require more working capital to cope with growth.

	Objective	% Increase
Current Assets	$3,085,000	18.3
Percent of Total Assets		10.3

A balance of **cash** and **marketable securities** helps to maintain enough cash for normal operations and increase profitability without reducing activities or jeopardizing the firm's abilities to meet its financial obligations. Cash and marketable securities include all funds readily accessible, such as bank and term deposits, and shares that can converted into cash in less than one year. As shown, total cash requirements will increase by 3.0 percent and represent 1.5 percent of total assets compared to 1.6 percent for the previous year. An analysis of these asset accounts should focus on the following questions:

- How does the firm balance cash and marketable securities?
- Will the amount sufficient to absorb all expenditures?
- Will the amount of cash be sufficient to take advantage of business opportunities, such as cash discounts, advance purchases and one-time offers?

	Objective	% Increase
Cash	$160,000	5.3
Percent of Total Assets		0.5

	Objective	% Increase
Marketable securities	$285,000	1.8
Percent of Total Assets		1.0

	Objective	% Increase
Total cash and marketable securities	$445,000	3.0
Percent of Total Assets		1.5

Prepaid expenses include payments made for services not yet provided, such as rent, insurance, office supplies and property taxes. On TravelWorld Inc.'s statement, it shows a 3.0 percent increase over the previous year. Expressed as a percentage of total assets, prepaid expenses will remain unchanged at 0.6 percent. An analysis of this asset account should focus on the following questions:

	Objective	% Increase
Prepaid expenses	$170,000	3.0
Percent of Total Assets		0.6

- What is the composition of prepaid expenses?
- What are the amounts for each prepaid account?

Accounts receivable includes sales made to customers on credit. It represents money owed by regular customers and expected to be collected within a reasonable time period. There is often a close relationship between net sales revenue and accounts receivable: the more a business sells, the more accounts receivable increase. In the case of TravelWorld Inc., net sales revenue will increase by 11.5 percent while accounts receivable shows a slightly smaller increment (11.1 percent). This means that TravelWorld Inc. will collect its accounts slightly faster than the previous year (19.65 versus 19.58 days). An analysis of this assets account should focus on the following questions:

	Objective	% Increase
Accounts receivable	$1,500,000	11.1
Percent of Total Assets		5.0

- What is the aging of the accounts receivable in dollars and on a percentage basis (30 days, 60 days 90 days, over 90 days)?
- What percentage of total net sales revenue is made on credit?
- What are the firm's credit insurance policies?
- What are the typical credit terms (i.e., 2 percent/30 days)?
- What is the estimated bad debt account?
- What are the collection procedures?

The **inventory** account assigns a monetary value to materials purchased and goods produced. There is a close relationship between cost of goods sold and inventory: typically, the more a business produces, the more its inventory increases. In the case of TravelWorld Inc., cost of goods sold will increase by 11.1 percent while inventory is expected to rise substantially – by 47.0 percent. This means that TravelWorld Inc. will turn around its inventory more slowly (19.71 versus 14.91 times). An analysis of this asset account should focus on the following questions.

	Objective	% Increase
Inventory	$970,000	47.0
Percent of Total Assets		3.3

- How much money is invested in raw materials?
- How much money is invested in work-in-progress?
- How much money is invested in finished goods?
- What are the costs of maintaining and managing warehouses and other storage facilities?
- What are the costs of safety systems for protecting inventory?
- What are the costs of ordering goods (e.g., paperwork, transportation and handling)?
- What are the holding costs (e.g., warehouse expenses, interest charges)?
- What inventory management systems are in place?
- How much insurance coverage does the firm have?

Capital Asset Accounts Planning Assumptions

Gross capital assets includes the book value of all physical assets purchased by the company and still recorded in its books, such as land, buildings, equipment, machinery and tools. TravelWorld Inc.'s gross capital assets are expected to increase by 14.5 percent. This account is offset by accumulated depreciation. As shown, accumulated depreciation will increase by 33.5 percent, resulting in a net capital account of $26,470,000 – a net increase of 8.1 percent. As shown, net capital assets are the largest investment in TravelWorld Inc. – 88.8 percent of all assets. An analysis of capital asset accounts should focus on the following questions:

	Objective	% Increase
Gross capital assets	$37,500,000	14.5
Percent of Total Assets		125.8

	Objective	% Increase
Accumulated depreciation	$11,030,000	33.5
Percent of Total Assets		37.0

	Objective	% Increase
Net capital assets	$26,470,000	8.1
Percent of Total Assets		88.8

- What type of assets will be purchased next year (e.g., equipment, machinery, buildings and vehicles)?
- How much will be invested in each asset?
- When will these acquisitions take place?
- What departments or divisions will benefit from these capital assets?
- What amount will be invested for modernization, acquisitions and expansions?
- Which capital assets be sold and at what price?
- What is the amount of depreciation for each category of asset? What are the rates?

Liabilities

Liabilities are all short and long-term debts incurred to purchase company assets. TravelWorld Inc.'s total debts will decrease by 5.3 percent. As shown on the balance sheet, total liabilities amount to $9,871,000, representing 33.1 percent of total debts and shareholder equity (compared to 38.2 percent for the previous year). Debts are divided under two major categories: current liabilities and long-term debts.

Current Liabilities Planning Assumptions

Current liabilities is the short-term debt required to finance the purchase of current assets. During the budget year, TravelWorld Inc.'s current assets will increase by 18.3 percent, compared to an increase of 26.5 percent in current liabilities. This means that the current ratio will show a drop in the level of liquidity (from 1.81 to 1.69 times). Expressed as a percentage of total liabilities and shareholder equity, current liabilities will jump from 5.3 to 6.1 percent. The most important current liabilities include accounts payable, bank loans (notes payable or working capital loan) and accruals.

	Objective	% Increase
Current Liabilities	$1,821,000	26.5
Percent of Total Liabilities & Equity		6.1

Accounts payable represents credit obtained from suppliers. As shown, this account shows an increase of 33.3 percent. Expressed as a percentage of total liabilities and shareholder equity, accounts payable will increase from 3.3 to 4.0 percent. An analysis of the accounts payable account should focus on the following questions:

	Objective	% Increase
Accounts payable	$1,200,000	33.3
Percent of Total Liabilities & Equity		4.0

- Who are the major suppliers?
- What amount is owed to the most important suppliers?
- What terms or agreements are made with these suppliers?
- What is the average daily payment?

Notes payable and **working capital loans** include short-term loans from financial institutions to finance the acquisition of current assets accounts such as accounts receivable and inventory. For TravelWorld Inc., these loans will amount to $535,000 and show an increase of 13.8 percent over the previous year; they will represent 1.8 percent of total liabilities and shareholder equity, compared to 1.7 percent for the previous year. An analysis of the notes payable and working capital loans should focus on the following questions:

Bank loans	Objective	% Increase
Notes payable	$400,000	14.3
Percent of Total Liabilities & Equity		1.3
Working capital loan	$135,000	12.5
Percent of Total Liabilities & Equity		0.5
Total	$535,000	13.8
Percent of Total Liabilities & Equity		1.8

- Who are the short-term lenders?
- What amounts were borrowed from each lender?
- What are the interest rates and the agreements?
- Which assets were financed with these loans?

Accrued liabilities represent monies owed for services received and not yet paid for, and expenses incurred but not yet recorded. This could include accumulated vacation and sick leave pay, interest on debt not due by year-end, property taxes related to the current year that remain unpaid, and warranty or guarantee work to be done during the following year on products already sold. As shown, TravelWorld Inc.'s accrued liabilities will $86,000, an increase of 22.9 percent over the previous year. Expressed as a percentage of total liabilities and shareholder equity, accruals will remain at 0.3 percent. An analysis should focus on the following questions:

	Objective	% Increase
Accruals	$86,000	22.9
Percent of Total Liabilities & Equity		0.3

- What is the nature of the accruals?
- What is the amount for each item?
- When will these amounts be paid during the following budget year?

Long-Term Debts Planning Assumptions

Long-term debts are accounts not due for at least one year. They include items such as mortgages, contracts, loans, notes and bonds. TravelWorld Inc.'s statement shows $8,050,000 in long-term debts, a decrease of

10.4 percent over the previous year. Expressed as a percentage of total liabilities and shareholder equity, long-term debts will fall to 27.0 percent from 32.9 percent for the previous year. An analysis should focus on the following questions:

	Objective	% Decrease
Long-Term Debts	$8,050,000	-10.4
Percent of Total Liabilities & Equity		27.0

- Who are the firm's long-term lenders?
- What amounts were borrowed from each lender?
- What are interest rates and agreements are in effect?
- Which assets were financed with long-term loans?

Shareholder Equity Planning Assumptions

Another way to finance a business is through shareholder equity – money invested in a company by its owners. TravelWorld Inc.'s objective for shareholder equity is $19,939,000, an increase of 18.1 percent over the previous year. Expressed as a percentage of total liabilities and shareholder equity, it will rise to 66.9 from 61.8 percent for the previous year. Shareholder equity comes from two principal sources: capital shares and retained earnings.

Shareholder equity	Objective	% Increase
Capital shares	$ 3,700,000	2.8
Percent of Total Liabilities & Equity		12.4
Retained earnings	$16,239,000	22.3
Percent of Total Liabilities & Equity		54.5
Total shareholders' equity	$19,939,000	18.1
Percent of Total Liabilities & Equity		66.9

Capital shares represent the amount of money invested in the business by shareholders. In the past year, TravelWorld Inc. shareholders have invested $100,000. **Retained earnings** are profits left in the business by the owners of a firm. In essence, the owners reinvest these amounts in the firm rather than receive them as dividends. As indicated in TravelWorld Inc.'s statement of retained earnings, the firm will generate $3,162,000 in earnings and pay $200,000 in dividends. As a result, the company will inject $2,962,000 into the company, bringing its accumulated retained earnings to $16,239,000.

Statement of Cash Flows

Appendix 2.4 shows TravelWorld Inc.'s statement of cash flows, which projects the movement of cash generated by TravelWorld Inc.'s operating, financing and investing activities.

Operating Activities

Cash flow generated from operations reflects management's performance. As shown, operating activities will generate $5,843,000 through three activities: income after taxes adds $3,162,000, depreciation adds $2,770,000, while working capital accounts show a use of $89,000.

Financing Activities

Financing activities will show a cash outflow of $1,030,000. This is a result of an additional investment of $100,000 by shareholders and a $930,000 reduction in long-term debt. TravelWorld Inc. expects to pay $200,000 in shareholder dividends.

Investing Activities

TravelWorld Inc. will invest $4,750,000 to purchase capital assets and $55,000 in intangible assets.

Cash Account

TravelWorld Inc.'s cash flow forecast is quite strong, as internally generated funds will be used for all purchases of capital assets; the company also had enough additional cash to reduce its debt and increase its cash account by $8,000.

Glossary for This Guide

Accrual: Continually recurring short-term liabilities such as accrued wages, accrued taxes, and accrued interest.

Assets: Resources that a business owns to produce goods and provide services; there are tangible assets, such as cash, inventory, land, and buildings, and intangible assets, such as patents and goodwill.

Balance sheet: A financial statement describing a company's financial condition (assets, liabilities, and equity) at a specific moment in time.

Business plan: Document prepared by management that summarizes the operational and financial objectives of a business and lists detailed plans and budgets demonstrating how the objectives are to be realized. Unlike an investment proposal, a business plan is considered an internal document.

Current assets: Balance sheet accounts such as cash, accounts receivable and inventory.

Current liabilities: Debts that a business must pay within one year (i.e., accounts payable).

EBIT: Abbreviation for earnings before interest and taxes.

Equity: Funds provided by shareholders; on a balance sheet, owners' equity equals total assets minus total liabilities.

Financial statements: Financial reports including income statements, statements of retained earnings, balance sheets and statements of cash flows.

Financing activities: That portion of the statement of cash flows that shows how much cash was provided (or used) from external sources (e.g., sale of shares, borrowing or repaying a mortgage, payment of dividends).

Horizontal analysis: A method of tracking how individual accounts change between consecutive financial statements; measured as a percentage.

Income statement: Financial statement that summarizes revenues and expenses for a specific period of time.

Investing activities: That portion of the statement o cash flows that shows how much cash was provided (or used) to buy or sell assets (e.g., purchase or sale of a building).

Liabilities: Debts of a business.

Operating activities: On a statement of cash flows, the section describing how much cash was provided (or used) from internal sources (e.g., income after taxes, depreciation).

Pro-forma financial statements: Predictions of performance recorded as financial statements.

Retained earnings: Amount of money kept by a company after paying shareholder dividends.

Statement of cash flows: Financial statement that shows where funds come from and where they went.

Statement of retained earnings: Financial statement that shows the total amount of income retained since the business was created.