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King Abdul-Aziz university FACULTY OF TOURISM

FINANCIAL MANAGEMENT

HM 361

Foundations of Financial Analysis

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Foundations of Financial Analysis

Assoc. Prof. Dr. Reda Gadelrab
May, 2021




Learning Objectives

By completion of this presentation You should be able to:

- Identify the fundamental methods of financial analysis.
- Identify the Financial Management Cycle.
- Recognize the importance of comparing numbers to give them meaning.
- Identify the importance of measuring change and what it tells about the financial performance of a business.
- Explain how percentages are used in financial analysis to measure financial performance.
- Identify trends and understand their importance to financial analysis.

Recommended Textbook:

❖ Hales, J.A. (2005) Accounting and Financial Analysis in the Hospitality Industry, Elsevier Inc.

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Methods of Financial Analysis

- Analyzing financial reports and statements requires a fundamental understanding of **where** numbers come from, **how** they are organized and presented, **what** they mean, **what** they measure, and **how** they are used.
- This section discusses two concepts of working with numbers to analyze financial statements.
- First, we will talk about two important ways numbers are used in business. They are used to **measure financial performance** and to **provide a management tool** to use in operating the business.
- Second is the **Financial Management Cycle**. It is important to understand this process and **how** numbers are generated and used in business operations.

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Two Important Tools

I. To Measure Financial Performance:

- Numbers provide a way to determine how a business is performing.
- Measuring financial performance is historical in nature and uses the actual numbers or results from business operations.
- It tells us **what** the business has produced, and **it** compares and **evaluates** that performance to specific measures.
- It is looking back through the rearview mirror at operations.
- The three main financial statements are all used in measuring financial performance.

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Two Important Tools

I. To Measure Financial Performance:

- **The Profit and Loss (P&L) Statement** shows the revenues, expenses, and profits for a specified time period. Each month, accounting period, quarter, or year, the numbers produced by an operation are recorded in the **P&L** statement and tell whether the business revenue and profits are improving, declining, or staying the same.

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Two Important Tools

I. To Measure Financial Performance:

- **The Balance Sheet** shows the assets, liabilities, and owner equity of a business at a specific time. These numbers tell us whether the business is getting financially stronger by increasing assets or owner equity or if it is struggling and increasing liabilities. **The numbers also tell us** how the business is capitalized or started—with more debt than owner equity or with more owner equity than debt.

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Two Important Tools

1. To Measure Financial Performance:

- The Statement of Cash Flows shows how much cash is generated by a business and how effectively it is used in operating the business over a specified time period. **Cash and liquidity** are critical to the success of a business, and the numbers included in the Statement of Cash Flows tells us how cash is being acquired and used.

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Two Important Tools

2. To Provide a Management Tool:

- Numbers provide a way for managers to plan for varying levels of business volume.
- This can take the form of forecasting revenues, scheduling wages, implementing cost controls, expanding business operations, or preparing the annual budget.
- Numbers give managers feedback on their operations and then assist them in making appropriate changes.
- This aspect of using numbers is very valuable to a business because it is the process of taking the information numbers provided and applying them back to operating the business.

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The Financial Management Cycle

The financial management cycle is the process of producing, preparing, analyzing, and applying numbers to business operations. It deals with the flow and use of numbers in business operations. It includes 4 steps as follows:

1. Operations produce the numbers.

- ❖ All the activities involved in the daily operations produce the numbers that measure performance.
- ❖ In a hotel, the daily operations provide products and services to guests, including the rooms department, food and beverage outlets, gift shop, and any other department that produces a sales transaction with a guest.
- ❖ Numbers used in financial analysis have to come from somewhere, and that is the daily operation of the business.

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The Financial Management Cycle

2. Accounting prepares the numbers and provides financial reports and statements.

- ❖ At the end of the day, week, or month, the numbers resulting from all operations and activities are collected, summarized, and reported by the accounting department.
- ❖ These reports describe the operations and activities and are distributed to the appropriate managers for their review and use.

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The Financial Management Cycle

3. Accounting and operations analyze the numbers.

- ❖ Operations management and accounting management work together to review and analyze the reports.
- ❖ They look for changes, the **cause of the change**, and the **result of the change** to understand operations and determine ways to change and improve.
- ❖ **Together they have** operational experience and financial analysis experience and can identify any changes or improvements that need to be made to **ensure that productive operations continue**.

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The Financial Management Cycle

4. Operations applies the numbers back to the business.

- ❖ After reviews and discussions, the operations managers make any necessary changes to operations to correct or improve them.
- ❖ The ability to analyze quickly and accurately and then make any necessary changes is an important part of any business operation.
- ❖ **It enables the business** to constantly improve by being more productive or creating more value in the products and services that it provides.

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Comparing Numbers to Give Them Meaning

- Numbers need to be compared to something to have any meaning.
- A hotel has monthly sales of \$1 million. All this tells us is the sales level.
- How do we know if this is good or bad, up or down, acceptable or not acceptable?
- A fundamental concept of financial analysis is to compare a number produced by operations to an established number that will tell us if there was an increase or a decrease.
- The most common comparisons are to (1) last year, (2) budget, (3) forecast, (4) previous month or period, (5) pro forma, or (6) any other established goal.

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Comparing Numbers to Give Them Meaning

(1) Last Year:

- ❖ Comparing actual financial results to last year's actual results is a useful comparison.
- ❖ The first evaluation of financial operations is to show if operations are better than the previous year.
- ❖ The best results are if actual operations for the current year are better than last year and the budget.
- ❖ The worst results are if the current year is worse than last year and the budget.

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Comparing Numbers to Give Them Meaning

(2) Budget:

- ❖ Actual financial results for a month, quarter, or year are compared to the established budget.
- ❖ The budget is the formal one-year financial operating plan for a company.
- ❖ Budgets include planned increases in revenues and profits, and productivity improvements in costs and expenses.
- ❖ Comparing actual results to the budget shows whether the business is moving in the direction planned and budgeted and how close it is in meeting, exceeding, or missing the budgeted numbers.

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Comparing Numbers to Give Them Meaning

(3) Forecast:

- ❖ Forecasts update the budget.
- ❖ Whereas the budget is done once for the entire year, forecasts are done continually to adjust or relate to current business conditions.
- ❖ Forecasts can be weekly, monthly, quarterly, biannually, or can apply to the end of the year.
- ❖ They are important because they are more current and help project business performance compared to the budget.

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Comparing Numbers to Give Them Meaning

(4) Previous Month or Period:

- ❖ These comparisons are important because they identify trends in operations.
- ❖ A goal of any business is to continually improve.
- ❖ Examining month-to-month performance tells us the trend and direction of our operations.
- ❖ They can show improvements that we hope are the results of corrective action implemented by management to keep the company moving in the right direction.

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Comparing Numbers to Give Them Meaning

(5) Pro Forma:

- ❖ A new business does not have any historical operating information.
- ❖ Therefore, management, developers, and bankers prepare a pro forma based on market conditions and expected financial returns.
- ❖ The pro formas are estimates or projections of how these financial experts think the business will perform in the first year of operations.
- ❖ The pro forma is used for the first year of business operations and is then replaced by the budget, which is prepared based on the first year's actual performance.
- ❖ Pro formas are used to establish and identify initial business revenues and profits that will generate the cash flow necessary to repay loans and investments.
- ❖ In summary, it is the projected first year of operations prepared before actual operations begin.

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Comparing Numbers to Give Them Meaning

(6) Other Goals:

- ❖ **Occasionally** a business will establish other goals or benchmarks to compare actual performance.
- ❖ **Examples are** improving profit margins to meet an established goal, achieving specific revenue levels, or entering new markets.

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Comparing Numbers to Give Them Meaning

- Let's use our example to give meaning to the \$1,000,000 in monthly sales. Suppose that last year we did monthly sales of \$950,000; this year we increased that by \$50,000 to \$1,000,000, which is good—*sales are increasing*.
- **However**, if the budget was \$1,100,000, we missed the budget by \$100,000, which is not good—*our sales did not increase as much as we had budgeted*.
- Now let's analyze our \$1,000,000 monthly sales performance. Was it good or bad? We know we increased sales \$50,000 over last year, but we missed budget by \$100,000. The answer, then, is that our performance was both good and bad. It was good because we improved \$50,000 over last year. It was bad because we missed the budget by \$100,000.

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Comparing Numbers to Give Them Meaning

- The next question we have to ask is, “*Was the budget set too high?*”
- Comparing the budget of \$1,100,000 to last year’s actual sales of \$950,000 tells us that we expected (or budgeted) sales to increase \$150,000.
- We can also measure this increase in percentages by dividing the \$150,000 increase by last year’s sales of \$950,000 to get a budget percentage increase of 15.8%. That is an aggressive budget increase.
- If I were the manager of this business, I would be very happy to have the \$50,000 increase over last year (a 5.3% increase).
- I would also review the reasons we thought we could increase by 15.8% and analyze why that didn’t happen.

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Comparing Numbers to Give Them Meaning

- Comparing numbers to something concrete is essential to give any meaning to the numbers. This is particularly important for the P&L Statements.
- The Balance Sheet and the Statement of Cash Flow are analyzed more to look for changes from previous statements or to goals or benchmarks than to budgets. Typically there is no budget for these two financial statements. That is why they are compared to the previous month or period or to a goal.
- Remember to compare any financial report to last year, last month, the budget, the forecast, the pro forma, or the goal to give it meaning. Then we can tell whether operations are improving or not.

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Measuring Change to Explain Performance

- One of the most important elements of financial analysis is to be able to identify **where changes occur** and **what caused the change**.
- In a large business with many products and departments, an effective financial analysis of the financial reports **must locate** the department that is changing and identify the causes of that change.
- Is it in **revenues**—volume or rate? Is it in **expenses**—cost of sales, wages, benefits, or other **operating expenses**? Is it a **direct or indirect, fixed or variable** expense?
- One department or many departments may be affecting operations with **positive or negative changes**.
- Changes are identified by comparing actual performance to previous performance or a specific goal or measure. **These changes can be** for a month, a quarter, or a year.
- The more information that is obtained about the changes, the better chance that **good decisions** can be made to respond to the changes.

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Measuring Change to Explain Performance

- Changes, both positive and negative, are measured in terms of units, dollars, and percentages. These three measurements can tell us a lot about the **performance of a business**.
- From our \$1,000,000 monthly sales example, we have already looked at the **dollar increase** (+\$50,000 over last year) and the **percentage increase** (+5.3% over last year). We **know that** we have \$50,000 more sales dollars, a **positive change**. We **know that** we increased sales by 5.3%, also a **positive change**.
- Performing that same financial analysis process, our \$1,000,000 is \$100,000 **below the** budget of \$1,100,000 and 9.1% **below the budget**. We **know that** we have \$100,000 **fewer** sales dollars than budgeted, a **negative result**. Our 9.1% is also a **negative result** from our budget.

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Measuring Change to Explain Performance

- The final measurement is units. If the entire \$1,000,000 in monthly sales was from room revenue, our unit will be the number of rooms sold.
- Our accounting reports would tell us how many rooms were sold and what the average room rate was. Let's assume the average room rate was \$80.
- We can then calculate the number of rooms sold by dividing total room sales of \$1,000,000 by the average room rate of \$80, which gives us 12,500 rooms sold. That should match the number of rooms sold on our accounting report.

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Measuring Change to Explain Performance

- So now we have the units or volume—12,500 rooms sold—but we don't know if this is better or worse than last year's monthly sales of \$950,000. The answer will come from last year's accounting reports.
- If the report tells us that the average rate for last year was \$78 and 12,180 rooms were sold, we can multiply these together and get the monthly sales of \$950,000.
- Now we can compare our actual rooms sold this year of 12,500 to last year's rooms sold of 12,180.
- We can also compare this year's average rate of \$80 to last year's average rate of \$78.
- Take a minute to calculate the increases from last year in dollars, units, and percentages for this year's monthly sales of \$1,000,000 (Table I).

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Measuring Change to Explain Performance

TABLE I. Comparison Actual to Last Year

	Sales	Rooms Sold	Average Rate
This year	\$1,000,000	12,500	\$80
Last year	\$950,000	12,180	\$78
Dollar difference			
Percentage difference			

The Answers to Table I. Comparison Actual to Last Year

	Sales	Rooms Sold	Average Rate
This year	\$1,000,000	12,500	\$80
Last year	\$950,000	12,180	\$78
Dollar difference	\$50,000	320	\$2
Percentage difference	+5.3%	+2.6%	+2.6%

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Using Percentages in Financial Analysis

➤ Percentages are one of the three ways numbers are used to measure financial performance. They provide an additional dimension or perspective in financial analysis. Percentages measure relationships and changes and always involve two numbers.

Calculating Percentages:

- ❖ Percentages are the result of combining two numbers that define a relationship.
- ❖ A change in one number changes the resulting percentage.
- ❖ Both numbers can also change.
- ❖ When a percentage changes, it is important to know which number changed and what caused the change. For example:

Wage cost percentage equals wage expense dollars divided by the associated revenue dollars

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Using Percentages in Financial Analysis

Calculating Percentages:

- ❖ If our department wage expense is \$350 and our department revenue is \$1,000, our wage cost percentage is 35% ($\$350 / \$1,000$).
- ❖ Wage cost percentage can go up or down in two ways.
- ❖ An increased wage cost would result from our actual wage expense increasing or our revenues decreasing. Continuing our example:

1. $\$400 \text{ Wage Expense} / \$1,000 \text{ Department Revenue} = 40\% \text{ Wage Cost Percentage}$
2. $\$350 \text{ Wage Expense} / \$875 \text{ Department Revenue} = 40\% \text{ Wage Cost Percentage}$

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Using Percentages in Financial Analysis

Calculating Percentages:

- ❖ If our wage cost expense went up, we would analyze the labor numbers to see where the increase was and what caused the increase.
- ❖ In our first example, our wage expense went up \$50 to \$400, but our department revenue remained the same at \$1,000. This is not good because we spent \$50 more on wages but did not increase our output or revenues. The business operation was less productive.
- ❖ In our second example, our wage cost remained constant at \$350, but our department revenue went down \$125 to \$875. This is also not good because we spent the same amount on wages, \$350, but it resulted in less sales, \$875. Again, our business operation was less productive.

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Using Percentages in Financial Analysis

Calculating Percentages:

- ❖ When you identify where the changes occurred, then you can look for the causes of the changes and make any necessary adjustments to improve operations. Our corrective action will be different in each example.
- ❖ In the first example, we would look at our work schedule to make scheduling changes to get back to 35% wage cost.
- ❖ In our second example, we would look to the sales department to see what caused the drop in sales to \$875 and to determine how we can correct it.
- ❖ In either case, it is an important part of financial analysis to make any necessary changes in our work schedule to adjust to the forecasted production volumes and their corresponding sales.

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Using Percentages in Financial Analysis

What Percentages Measure :

- ❖ Percentages measure relationships and changes.
- ❖ An example of relationships is the previous wage cost example. A 35% wage cost means that 35 cents out of every revenue dollar is used to pay the wage cost associated with producing that revenue dollar.
- ❖ Another example is food cost percentage. An actual food cost percentage of 40% means that 40 cents out of every food revenue dollar is used to pay for the associated food cost to produce that one food revenue dollar.

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Using Percentages in Financial Analysis

What Percentages Measure :

- ❖ The food cost percentage will go up or down based on changes in food costs or food revenues.
- ❖ To become more productive and profitable, the actual food expense that results in a sale **would have to decline or stay the same**, but the food revenue would increase.
- ❖ To become less productive, our food cost would have to remain the same and our food revenues go down or our food cost would have to increase but our food revenues would remain the same.
- ❖ By looking at each number and identifying any changes, we analyze the numbers and identify what changed and how that affects our operational performance.

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Using Percentages in Financial Analysis

What Percentages Measure :

- ❖ Let's look at another example of percentages and change. If our revenues increase from \$1,000 to \$1,200, the resulting dollar change is an increase of \$200.
- ❖ To calculate the associated percentage change, divide the \$200 increase by the original \$1,000 revenue, and the result is a 20% increase in revenues. *The amount of change is always divided by the base, beginning, or original number.*
- ❖ Percentage change can be calculated for changes in revenues, expenses, profits, assets, units, liabilities, owner equity, or any other specific account.
- ❖ Using percentages in the process of financial analysis includes three steps. First is identifying and measuring the change. Second is identifying the cause of the change. Third is developing and implementing corrective action into daily operations.

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