

BOP Ltd

Banton's Online Photographics (BOP) Ltd. regularly checks its delivery reliability and customer satisfaction. Now, in early December (the most important part of the year), the level of customer complaints has risen from 3% to 11%. The problem has been caused by late deliveries. With Christmas looming, this is a problem.

Meanwhile, the firm's Finance Director is worried about another matter. The bank has been on the phone to ask why the BOP has twice gone beyond the limits of its overdraft facility in recent weeks. The bank manager is warning that the next time this happens, they will refuse to pay. This could make things very difficult with the firm's suppliers.

At this morning's Senior Manager's meeting, the Finance Director's concerns were swept aside by the Customer Services manager's loud complaints about some of the angry customers she had been dealing with. One had said: "Everything about your business stinks. The camera arrived 2 days late and I found the same camera at a different site for 10% less. You let me down so I cancelled the payment. You can come and pick up the camera; it arrived too late to give as a birthday present; you can pick it up in person."

Question

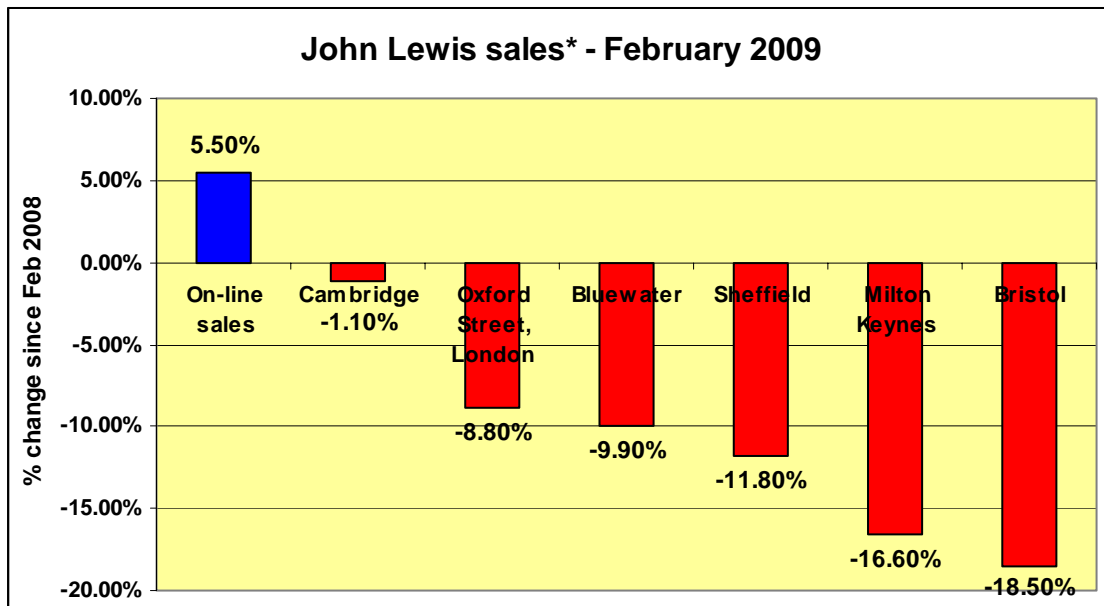
Use this information and the cash flow data below to answer the question: Discuss which is the more urgent problem for BOP management to tackle: the delivery problem or the cash flow problem. (12 marks)

BOP Weekly cash flows: actual figures to Dec 5th; forecast from Dec 12th

All figs in £000s	Nov 7 th	Nov 14 th	Nov 21 st	Nov 28 th	Dec 5 th	Dec 12 th
Cash at start of week	440	280	50	- 120	- 180	-180
Cash inflow	240	220	260	310	280	350
Purchases	220	260	250	170	80	160
Other running costs	180	190	180	200	200	190
Total weekly outflow	400	450	430	370	280	350
Net cash flow	- 160	- 230	- 170	- 60	0	0
Accumulated cash flow	280	50	- 120	-180	-180	-180

Managing in Tough Times

John Lewis is a chain of 27 department stores throughout Britain. It appeals mainly to middle class, middle-aged people. It is a fair measure of what is happening to sales of items such as clothing, household products and electrical goods. The graph shows that February 2009 was very tough.



*Sales in six selected stores, including the best and worst performers, plus the John Lewis website.

John Lewis is an unusual business because it has no shareholders. Its owners are the staff. Some people say this is great, because staff really care about the success of the business. Others think that it makes it difficult for tough decisions to be taken, such as to cut staff numbers or close loss-making shops.

Now, in the country's first recession since 1990, many shops are cutting back to help the business survive. What should the management of John Lewis be doing?

Discussion Points.

(Try to think of at least three good answers to each of these points.)

1. Why might the Bristol store be doing so much worse than the Cambridge one?
2. You are the manager of the Bristol store. You can see that the shop is starting to lose money. What could you do to turn the situation around?
3. In what ways might an employee-owned business such as John Lewis make different business decisions than a shareholder-owned business such as Debenhams?

Can Zavvi be Zaved?

On Thursday January 8th 2009 Zavvi announced the closure of 22 of its stores, with 178 people losing their jobs. This left 92 stores still open, but with the threat of closure hanging over them. As many as 3,200 more jobs will be lost if Zavvi closes down completely.

Zavvi was formed in September 2007. Before that, the stores had traded as Virgin Megastores. In the year to March 2006 the chain made losses of £82 million. In 2007 losses were around £50 million. But the chain's senior managers had the confidence to buy the business from Virgin - helped by being, in effect, paid £20 million to take the business off Richard Branson's hands. They renamed the stores Zavvi, but lacked the finance to be able to make many changes. Zavvi continued to sell CDs, DVDs in High Street stores. The business was hit in late 2008 by the collapse of Woolworth's music distribution business - which supplied Zavvi with its CDs and DVDs.

In 2008 DVD sales rose by 1.9%, but CD album sales fell 3.2%. But these figures are for the industry as a whole. Online sales probably rose, leaving shop sales down heavily.

Discussion - How might the remaining 3,200 jobs at Zavvi be saved?

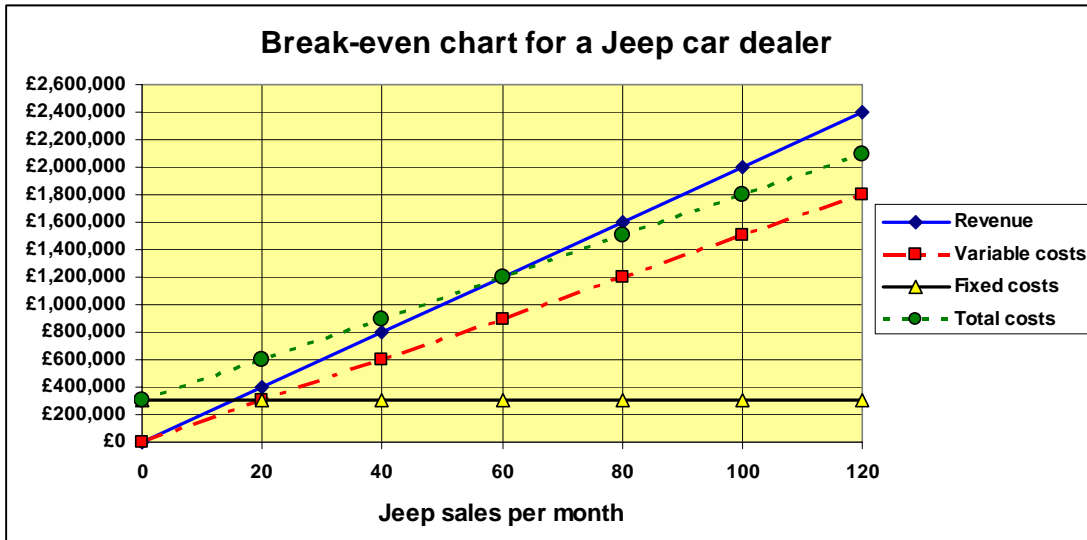
1. Jot down as many ways to restore Zavvi to profitability as possible.
2. Eliminate any that require a lot of short-term spending, as Zavvi currently has a very weak cash position.
3. Discuss between yourselves which you believe to be the single best approach to take. Prepare to explain your thinking.

Dealing in the Downturn

What do you do if demand for your products has slumped by 20%? Or what about 60%? Clearly you could be dragged from profit to loss, and cash flow could quickly become a serious problem.

This is the position of car dealerships up and down the country. A 17% fall in car sales in August has been followed by a 21% fall in September. Among the hardest hit have been Jeep showrooms. UK sales fell from 1,695 in September 2007 to just 660 in September 2008.

Explanations for the slump in Jeep sales are not hard to find. Higher petrol prices encouraged people to switch to smaller cars, as did consumer concern for the environment. Then came the economic downturn reinforced by increasing uncertainty about banks and the 'credit crunch'.



For a company owning 4 or 5 Jeep dealerships the position could quickly become a major concern. The business in the graph above has fixed costs of £300,000. Its Finance Director wants to act to cut these costs but the Managing Director believes 'that's foolish, we can't cut the fixed costs, we must focus on the variable ones'.

Economic downturns can catch out the businesses that are slow to react. Those running Jeep dealerships had better move fast.

Questions (25 marks; 30 minutes)

1. Briefly explain how a sales slump could 'drag' a business from profit to loss. (4)

- 2a) Calculate the % decline in Jeep sales between September 2007 and September 2008. (3)

- 2b. The Jeep dealer featured in the break-even chart sold 100 Jeeps in September 2007 but only 40 in the same month this year.

 - 2bi. What profit did the business make last September? (3)
 - 2bii. And what profit/loss did it make this September? (2)

- 3a) Help the Finance Director to explain why fixed costs can be cut. (4)

- 3b) Explain two ways in which this Jeep dealer could return itself to break-even. Discuss which is the better option in the difficult 2008 car market. (9)

Mark Scheme

1. Briefly explain how a sales slump could drag a business from profit to loss. (4)

- It's clear to see on the break-even chart; a fall in sales means a shift to the left, i.e. revenue declines making it ever harder to cover the fixed costs.
- Profit is the difference between revenue and costs. The lower the revenue the harder it is for the revenue to be greater than the costs.

2a) Calculate the % decline in Jeep sales between September 2007 and September 2008.

% change = change/original x 100

Change = 1695 - 660 = 1035 Jeeps % change = 1035/1695 x 100 = -61.1%

2b. The Jeep dealer featured in the break-even chart sold 100 Jeeps in September 2007 but only 40 in the same month this year.

2bi. What profit did the business make last September? (3)

Revenue £2m (1) - Total costs £1.8m (1) = Profit £200,000 (1)

2bii. And what profit/loss did it make this September? (2)

Revenue £800,000 - Total costs £900,000 (1) = Loss £100,000 (1)

3a) Help the Finance Director to explain why fixed costs can be cut. (4)

- They are 'fixed' only in relation to output or sales; otherwise they can rise or fall and can certainly be cut, e.g. by moving Head Office to smaller, cheaper premises
- For a car dealership, fixed costs that could be cut include staffing (cutting the salary bill) and advertising (though that might be very foolish)

3b) Explain two ways in which this Jeep dealer could return itself to break-even. Discuss which is the better option in the difficult 2008 car market. (9)

Level 3: candidate considers the pros and cons and draws a well-judged conclusion
7 - 9

Level 2: candidate applies sound knowledge to the business context
4 - 6

Level 1: candidate applies basic knowledge
1 - 3

- It could attempt to rebuild sales, to move at least to the break-even sales level (60 cars); this would require some very clever marketing given how 'wrong' the Jeep product is in the context of 2008; the risk would be of carrying out an expensive marketing campaign that has hardly any effect on sales (increasing the losses)
- Alternatively it could cut costs; this seems the more sensible option, but it's clear that there isn't a huge amount of scope for cost-cutting. The only really significant cost may be the land the dealership is on (i.e. property rental) but moving location may risk losing a lot of the regular customers; staff can be cut back, but there are unlikely to be any meaningful variable cost savings to make, as the dealer still needs to buy Jeeps from the same car manufacturer

Overall, cost-cutting is a more certain way to improve profit than attempting to boost revenue. At times like these, safety first seems the best policy.

Break-even test (40 marks; 40 minutes)

1.	How do you calculate the amount of revenue that comes in from a firm's sales?	(2)
2.	At a McDonalds, which of these are fixed and which are variable costs?	
	Burgers	Store manager's salary
	Lighting	Gas for cooking
	Paper bags	TV advertising
	Tables and chairs	Cooking equipment
		(8)
3.	A baker's variable costs per loaf of bread are 40p. The daily fixed costs are £120. If 250 loaves are sold at £1 each, calculate the daily:	
	a) Revenue	
	b) Total costs	
	c) Profit	(6)
4.	Explain the meaning of the term 'fixed costs'.	(3)
5.	French Connection has suffered a sharp fall in profits. Outline three ways it might act to increase its profits.	(6)
6.	Identify the:	
	a) Break-even level of output	(1)
	b) Profit/loss if Sparks Ltd sells all it can make	(1)
	c) Profit/loss if 100 units are sold	(1)
7a)	Explain the meaning of the term 'margin of safety'.	(3)
7b)	State the margin of safety for Sparks Ltd, if its sales are currently 400 units.	(3)
8.	Examine one advantage and one drawback to the use of a break-even chart when deciding whether or not to increase the selling price of a product such as a Mars bar.	(6)

Answers:

1. Price (1) x quantity sold (1) {accept output}
2. V.C.: burgers, paper bags, gas for cooking
FC: lighting, tables and chairs, salary, TV advertising, cooking equipment

NB for techies, of course the super-correct answer on FC is depreciation on cooking equipment & tables and chairs; but the key thing here is to encourage them to grasp what variable costs and fixed costs really mean (and that seems bizarrely difficult)

3. Rev £250 (1 mark)
Total costs: Fixed costs + Variable costs (1 mark)
 £120 + (40p x 250) (1 mark)
 £220 (1 mark)
Profit = Total revenue - Total costs (1 mark)
 = £30 (1 mark)
If the student just writes down £30, give 2 marks for the profit calculation.

4. Costs that do not change just because sales/output changes (2), e.g. rent (1)

GIVE 0 marks for a definition that just says 'costs that don't change'

5. Cut variable costs, e.g. by finding lower-cost suppliers
Cut fixed costs, e.g. by reducing the head office staffing level
Boost sales, perhaps by paying closer attention to the motivation of shopfloor sales staff

- 6 a) 300 units
b) £3,000
c) -£3,000

- 7a) The amount by which demand can fall before you start making losses (2), i.e. sales *minus* break-even output. (1)

- 7b) 100 units

8. Advantage: Helps set out the possible profits at a range of possible sales levels. The rising incline of the revenue line boosts profit per unit of output, but falling demand may counterbalance the effect.

Disadvantage: The chart gives you no idea about what the effect will be on actual sales and therefore actual profit. Therefore the break-even chart must be supplemented by market research.

The Ho Li Takeaway

Chan Ho and his wife Li came to London from Hong Kong in 2007. They had £4,000 of savings, borrowed £6,000 from an uncle and started up the Ho Li Chinese Takeaway in Tooting. The kitchen was short of equipment, as they couldn't afford much. But Li was such an inventive cook that Chan was not worried.

The takeaway opened on February 1st 2008. Weekly fixed costs were £800, and Chan estimated taking £2 profit from each customer. Unfortunately the first week went very slowly, with only 100 customers. By week 8 sales had trebled, and customers were coming in saying they'd heard the food was great. Li was very happy, but Chan kept tapping on the keys of his calculator, worried. He had to go back to his uncle, asking to borrow an extra £1,000, which he found embarrassing.

By March 2009, the position was transformed. Word of mouth had spread and around 600 customers were coming per week. Even better, the average customer spent £8, with variable costs of £5. They were making a profit of £1,000 per week! They needed more staff, but there was no room in the tiny kitchen for more than Li.

Flushed with success, Chan offered £10,000 for the 2 year lease on the (struggling) shop next door. It was accepted, and builders came in to provide Li with a much bigger kitchen. In fact, it took much longer to sort things out than they expected, and it was only in December that the new, expanded takeaway was ready. In the meantime all their profit had been invested in the building work and new equipment.

December 2009 proved terrific, but sales simply would not pick up after Christmas. By April 2010 the position was worrying. They were no longer making real profits. It was time for a careful re-think. What could have gone wrong?

Questions (20 marks: 30-40 minutes)

1. Why was Chan still unhappy with the sales at week 8? Calculate the profit/loss being made. (3)
2. Outline two things that might have caused sales to be slow when the business started up. (4)
3. Prove that the business was making £1,000 profit per week in March 2009. Show your workings. (3)
4. Discuss what could have gone wrong for the business after December 2009. (10)

Cash flow - how to improve it

1. Missing words

All businesses should aim to keep a _____ net cash flow position. Negative net cash flow means that a business does not have enough cash coming into the business to pay for its cash expenses. This may force the business to apply for an overdraft as a _____ solution; this is expensive if used in the long term. A firm must make sure, therefore, that cash _____ are larger than cash _____.

Hint:
words from - inflows, outflows, positive, short-term

2. Improving cash flow: multiple choice questions:

2.1 Which two of the following would be most likely to keep a firm's cash flow positive in its first year of trading?

- a) Ignore late-paying customers to maintain a good relationship
- b) Rent equipment rather than buy it outright
- c) Run expensive advertising campaigns frequently to increase demand
- d) Control running costs as much as possible
- e) Agree a large overdraft facility with the bank

2.2 James Smead Ltd produces clothes for department stores in the UK. Which two of the following are most likely to help the company recover from a negative cash flow position?

- a) Sell off any unused machinery and equipment
- b) Increase the salaries of sales staff in order to encourage them to work harder
- c) Reduce the price charged to its customers for all new orders
- d) Increase the price charged to its customers for all new orders
- e) Offer existing customers a small discount for paying on time

3. Improving cash flow: Samir and Sabina are catering students who want to set up in business together. They plan to provide a service preparing the food for private parties in their local area. They have prepared the following cash flow forecast as part of their business plan. They had expected initial sales to be low but are disappointed with the results. Fill in the gaps and answer the questions that follow:

	February £s	March £s	April £s
Cash inflow	10,000	1,000	1,400
Delivery van	7,000	0	0
Kitchen equipment	2,000	0	0
Others	600	1,300	1,650
Total cash outflow	a)	1,300	1,650
Net cash flow	400	b)	d)
Opening balance	0	c)	100
Closing balance	400	100	e)

4. Improving cash flow - match the action to its most likely effect

Action to improve cash flow	Likely effect
1. Sell the Head Office building and rent one instead	a) Cash inflow will increase, but costs will be higher in the long term.
2. Sell off machinery that is not being used.	b) Cash inflow may increase but profits will decrease.
3. Hold a '20% off everything' sale	c) Cash inflow will increase immediately but cash outflow may also increase.
4. Offer customers a discount for prompt payment.	d) Cash inflow will increase but the business may not be able to respond to a sudden increase in demand.

14. ANSWERS - Cash flow how to improve it

1. **Missing words** - positive ... negative ... insolvent ... temporary ... inflow...
outflow

2. Improving cash flow: multiple choice questions:

2.1 b) d)

2.2 a) e)

3. Improving cash flow: calculations

a) £9,600 b) (£300) c) £400 d) (£250) e)
(£150)

4. Improving cash flow - consequences

4.1 a)

4.2 d)

4.3 c)

4.4 b)

That's why suppliers won't go to Iceland

On November 29th 2007 Icebox Holdings (owners of Iceland frozen food stores) wrote to all its suppliers. The letter said that the retail company had decided to extend its payment terms from 45 to 90 days. In other words, instead of paying the supplier 6 weeks after products had been delivered to the stores, it would now wait 13 weeks (interest free) before paying.

To add insult to injury, the letter also announced a 2.75% discount for paying 'on time'. In other words if Iceland paid in 89 days it would take 2.75% off the value of the bill being paid. The letter informed suppliers that the new conditions would be brought in on January 1st 2008. The boss of a major supplier to Iceland responded by saying 'a 2.75% discount on our prices is a significant cut into our profit margins. At a time when our costs are rising, our prices should be going up not down'.

Small and medium-sized food manufacturers wrote of their anger to The Grocer magazine and to their employers' association, the British Frozen Food Federation. Some have threatened to stop dealing with Iceland rather than accept the terms. Larger producers such as Birds Eye and McCain have made fewer protests, perhaps because they are too big to be 'pushed around'. It will be the smaller firms that suffer most. As one supplier put it: 'If you have high borrowings and Iceland is 40% of your business, then you're going to be worried'.

Iceland's marketing director seems unconcerned at the anger of some firms, saying that 'suppliers who have been with us in the past two or three years have seen big growth and done well'. It is true that Iceland has grown recently due to sharp pricing and the 'That's why mums go to Iceland' TV campaign. The marketing director's lack of concern about suppliers' views seems, in effect, to be 'like it or lump it'.

Discussion Points

(Talk them over with your neighbours and get ready to present your findings to the class)

1. Decal Farms is a small supplier of frozen raspberries; 40% of its sales are to Iceland Foods. Discuss the possible impact of these new payment terms on Decal's cash flow.
2. Discuss why a firm such as Birds Eye may be much less worried about the changes than a firm such as Decal Farms.
3. Discuss what Decal Farms should do to improve its cash flow after the new terms come in on January 1st 2008.