INTRODUCTION AND LEARNING OBJECTIVES

A basic understanding of financial management is essential for managers in the tourism industry. Financial management is central to planning, measuring and controlling many activities and managers that understand and can use this information can act on it more effectively. The learning objectives then focus on those dimensions of financial management most relevant to a manager’s effectiveness. This chapter’s objectives are:

- to develop an understanding that accounting systems and reports may be adapted to specific management needs;
- to develop a comprehension of the profit and loss statement and the effects of management decisions on it;
- to develop an appreciation of the differences between profit and cash flow and the effects of management decisions on cash flows; and
- to present a perspective on the balance sheet that reveals its relevance for managers.

It is useful to distinguish between differing levels of financial management: (i) some decisions focus on an organization’s strategic concerns – those that involve major, long-term commitments; (ii) other decisions focus on what may be termed tactical concerns – those involving more modest, yet still significant concerns in the short to intermediate term; and (iii) operational financial management is concerned with day-to-day and very short-term issues (Fig. 10.1). It should be noted that these are inter-related for the strategic decisions an organization makes to determine what its shorter-term resources and capabilities may be. Financial accounting is related to financial management, particularly in the short term, where monitoring the financial effects of activities and managing those effectively can be critical.
Many of the systems used by financial accountants are useful for management purposes. The prime orientation of financial accounting systems focuses on acquiring information necessary for keeping accounts – tracking sales, cash, stocks, etc. in an organization’s day-to-day operations. But just as an accountant is interested in knowing exactly how much was sold and the incoming revenues for their financial statement preparation reporting on the organization’s assets and liabilities, its profits and losses, so too will managers have their own interests in knowing what services are selling, where those sales are occurring, who is buying the services, what prices are being paid, whether a recent sales promotion is having an effect, and a myriad of other aspects of the organization’s activities. The financial data may be mined extensively for useful information if the appropriate information systems are in place. And it is a strategic decision to install and operate these systems so that the organization’s competitive capabilities are enhanced.

Even relatively small organizations will generate hundreds, if not thousands of financial transactions in a day. In the past the effort required to collect, extract, categorize and then analyse the information of the greatest use for management has been too onerous. The legally mandated financial controls and reports produced by accounting systems may, through design and implementation efforts that more fully consider the organization’s needs, be augmented by further controls and reports that provide better information. Accounting information may now be used as never before to help with a manager’s understanding of their efforts and their impact.

**FINANCIAL ACCOUNTING AND FINANCIAL MANAGEMENT**
The fundamental unit of financial activity is a transaction – the exchange of money for goods or services. Financial accounting monitors these and records their effect. When something is purchased the customer surrenders either cash or a promise to pay in exchange for a good or service, or for the organization’s promise to provide it in the future. No single transaction generally has much significance but when all are taken together and their collective effect is gauged the organization may then understand how well it is doing. With thousands of transactions occurring the volume of data is enormous and its organization and presentation very difficult. Accounting information systems have been developed to handle these demands and to provide summarized reports and controls required to effectively manage the finances. These systems may also be exploited by non-financial managers: operations and marketing managers share an interest in knowing what capacity remains after sales have occurred, and understanding what is selling provides insight into what needs to be promoted and how it might best be used. Finance, marketing and operations all interact and the information vital to one is often just as important within the other functions.

A brief consideration of the profit and loss statement will illustrate the interests managers will have in the financial information acquired and used by accountants. One critical issue and potential problem is that such accounting information only describes what has already happened, and while this may be useful for short-term responses in the immediate and near future its value for longer-term decisions and marketing developments is more limited. Nevertheless, a sound understanding of the past is usually necessary for a well-founded extrapolation or consideration of how future developments might unfold.

Financial statement analysis from a management perspective

The two main financial statements developed by accountants are: (i) the profit and loss statement; and (ii) the balance sheet. These are required by law for all corporations for their annual reports and they are also useful to managers in providing an overview of an organization’s operations. From a manager’s perspective these are particularly useful when produced more frequently or in greater focus and detail to allow specific questions or issues to be investigated. For example, a profit and loss statement for a particular service or sales region might help in analysing its economic benefit. The balance sheet is rather less useful but some real benefit may be obtained through an analysis of the assets and liabilities that are affected by management initiatives and policies, particularly when strategic decisions involve acquiring long-term assets using liabilities such as debt.

The chief difficulty with most treatments of financial statement analysis is their focus – a consideration of the information from an accountant’s point of view rather than that of a manager. Managers of operations, personnel and marketing could find much value in this data if only it were refined in ways to maximize its usefulness in those areas. So long as the preparation of these statements is dominated by purely financial and regulatory requirements, organizations will find they are not extracting the maximum benefits from the data collected. A proactive approach may help design systems that produce information more useful than that seen in the usual sets of accounts produced.

One point to recognize with financial statement analysis is that the information is all historical – it shows the effects of past policies and decisions. In their most commonly seen format they can reveal what happened over the past year (or quarter, if public accounts are produced that frequently). Yet managers will require information more frequently – generally monthly and perhaps even weekly or daily. But even the most current accounting reports will always describe events that have already occurred. This information can be very valuable but it does not necessarily allow marketing efforts to be managed as they are happening.
The profit and loss statement and how managers can use it

The profit and loss statement is perhaps the most useful of the accounting reports commonly used. It summarizes the organization's income from sales, the costs incurred in generating those sales and the overhead expenditures necessary to support the sales activity. This information is presented in a coherent format that allows the different pieces of information to be considered individually, and in relation to other relevant issues. A manager may easily see what the sales revenues for the period have been. Going beyond that simple information they may then look at related information: (i) how much were the costs of making those sales; or (ii) how did the current period's sales change from the previous periods; or even (iii) how the current period's sales compare with the same period in a previous year if that is more relevant (as it often is in tourism businesses affected by seasonal factors). The profit and loss statement can be constructed to provide a more precise focus too if necessary – it may be broken down to focus on specific services or regions (and their costs), or any other aggregation in which the manager may have a specific interest in assessing. The information can be acquired and a close working relationship with an organization's accountants can help design systems that allow this information to be easily and effectively collected and reported from the mass of accounting information handled.

Table 10.1 illustrates a common format for profit and loss statements. This also provides a line-by-line synopsis of each entry for management. Besides the raw figures from the profit and loss statement there are a number of relationships that may also be used to explore the organization's performance. These interesting relationships are most often identified through financial ratio analysis, an important tool used by accountants in assessing corporate financial performance. Some of these ratios reflect an organization's competitive and marketing performance and so have a specific relevance to managers.

A frequently used measure of marketing performance and operations efficiency is the gross profit margin: gross profit/sales revenue. This effectively is the difference between the selling price and the direct costs of the goods sold or services provided. The key point to recognize is that this should be considered as showing 'symptoms' of a problem and is not itself the problem. For example: the gross profit margin may fall from one year to the next and raise concern, but without further investigation the most appropriate response cannot be identified from that simple measure. The margin may have fallen because prices have 'softened' due to competitor pressure: (i) price-cutting by existing competition; (ii) improved competing services; and/or (iii) new entrants into the market, etc. Or it could also be due to customer behaviour: (i) tastes may change; (ii) incomes may not rise as expected; or (iii) changes in behaviour as a result of even more general macro-economic factors such as interest rate changes, inflation or exchange rate variations. The ratio provides an insight into performance, but does not explain why that varies. Explanation requires a closer review of revenues, prices, volume sold, unit costs, etc. – the whole range of factors that affect gross profit.

While selling and administrative expenses are generally presented as an aggregate, an analysis that breaks these down so that the selling costs may be considered on their own is most useful. In this the ratio of selling overheads to sales revenue would be a critical interest. Advertising and other promotions often require expenditure prior to the realization of sales – these fixed costs then need to be recovered by the sales they help generate. If the level of sales is greater than expected then a lower cost:revenue ratio may be seen, if sales are not stimulated as much as desired a lower ratio may be observed. The 'target' or desired ratio may be set arbitrarily or taken from past experience. Differences from the target, or past years' experience may again be explained by other factors: (i) advertising costs may be increasing faster than sales revenue
Table 10.1. Profit and loss statement and implications for management.

<table>
<thead>
<tr>
<th>Profit and loss statement</th>
<th>Current year (£)</th>
<th>Previous year (£)</th>
<th>Implications for management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales revenue</td>
<td>1500</td>
<td>1250</td>
<td>This is the level of sales in monetary terms. Are sales reaching desired levels? Is there a minimum level of sales necessary? Are sales increasing, decreasing or stable? Related questions are: Are revenues per unit sold stable, increasing or decreasing? Is the item's price 'right'? Is it being discounted? Are competitors affecting sales – and if so is it volume or price most affected? Not only are changes in value considered but also proportionate changes are usually considered too. A £1 million increase in sales might be great for a small company but not so impressive for a much larger one. Comparative changes are important too, for a company may find that its results should not be considered in isolation but also in reference to its nearest competitors and the industry or economy more widely. Thus a set of 'good' results may lose some of their shine if others are doing even better yet; or gain more if those competitors are doing more poorly.</td>
</tr>
<tr>
<td>Cost of goods sold</td>
<td>750</td>
<td>650</td>
<td>This reflects the unit costs of the items or services sold. These may include purchase or production costs, distribution costs and direct sales commissions. Are these increasing or decreasing proportionately with sales? These can be a measure of efficiency in production, or a measure of how effectively suppliers are controlled.</td>
</tr>
<tr>
<td>Gross profit</td>
<td>750</td>
<td>600</td>
<td>This is also called a contribution margin. This is a broad measure of the profitability of the goods and services sold. Its interest to managers is that it is a better guide for sales promotions than simple price or volume. Increasing the sales of the most profitable services is one financially oriented objective that managers may identify.</td>
</tr>
<tr>
<td>Selling and administrative costs</td>
<td>500</td>
<td>400</td>
<td>General administrative costs would be a concern for managers – these represent the office and support staff that facilitate operations; most organizations try to utilize these as efficiently as possible, although there is no direct link between them and the sales volumes achieved. Some marketing and selling overhead costs certainly would be closely considered. These would include such issues as advertising and other promotional costs and their link to sales generated with implications for future marketing effort.</td>
</tr>
</tbody>
</table>

(Continued)
Other fixed costs | 100 | 100 | These are usually outside the day-to-day control of managers, though they may be varied over the longer term by investment or dis-investment, or changes to the assets base of the organization. Examples of such costs could be items like depreciation of assets, insurance, rent, utility costs, etc. One point to recognize is that investment in new service development may be classified as an overhead in this category. Expanding, or upgrading facilities would generally involve investments that would affect these.

Profit | 150 | 100 | This value is how much money is being made from the organization’s operations before interest and tax. This is an important number for it represents a measure of the organization’s performance independent of the manner in which it has financed itself. Thus two companies might be equally successful in their activities but find that the choices made in financing their operations create cost differentials. This value is thus more suitable for comparisons between periods or companies that finance themselves differently.

Interest charges | 50 | 50 | These are the costs of money borrowed to sustain operations. This too may not generally be a concern for managers.

Taxes | 50 | 25 |

Net profit | 50 | 25 | How much money is made after tax, it’s then available for distribution to the organizations shareholders or owners as dividends or profits; or it may be retained to provide additional working capital or money for reinvestment within the business in the future.
yielding a higher cost:revenue ratio; or (ii) a promotion may be more successful in stimulating sales revenues than expected yielding a lower cost:sales ratio. A disaggregated set of revenues and costs would then attempt to link specific overhead expenditures for a given product’s or service’s selling, advertising, promotion and development costs to the revenues it yields.

This information may then be compared with the plans previously developed and performance against the plan assessed. Questions may then be posed: Was the plan successfully implemented? If not, what problems were there? (Higher than expected costs? Delays in promoting the product? Delays in delivery? Problems in distribution?) In essence, the effectiveness of the plan and its implementation may be assessed. A proper ‘audit’ of operations and marketing may then indicate successes to be emulated or failures to be avoided in future plans and activities.

The profit and loss information is just one tool used to manage an organization's operations. It is usually supplemented by a cash flow analysis: managers recognize that profits are only part of the story in running their organizations.

**Adjustments to ‘profit’: cash flow and managing it**

The cash flow analysis that follows from the profit and loss statement requires a number of ‘adjustments’ in order to understand the real impact on the organization's cash position from a period’s operations.

Profit is the starting point. But some of the fixed costs deducted generally are depreciation – simply an allocation of past investment in productive assets to the current and future periods with the purpose of more accurately reflecting the true costs of doing business over the life of an asset, rather than force all of its costs on to the period when it was acquired. Thus depreciation is a non-cash expense for an organization: one that it has to recognize to properly assess its profitability, but not one that currently costs it any money. Depreciation is effectively money spent in the past that is treated as a current cost, so the true cash position for an organization would look to its profits and add back to them the depreciation previously paid. This generally improves the situation (more cash available for paying debts and other uses), but against that there may be a number of deductions.

It is common for many businesses in the hospitality and tourism industries to face significant overhead costs associated with their facilities, equipment and even the staff they use. In these cases there may be significant benefits to a clear understanding of how sales and demand promotions can affect the overall short-term financial performance of the organization. In these cases financial management can play a significant role.

First, there are inventories to consider. An increase in inventories will require money. These inventories are not shown on the profit and loss statement but will be shown later on the balance sheet. A decrease in inventories has an effect like depreciation: stock created and paid for in the past is currently being sold. Those earlier costs are now shown on the profit and loss as a cost, but they were one paid in the past. So current sales of inventories previously created brings in more cash through recovering those earlier costs. In effect the profits from past sales have been stored in inventories until those stocks have been sold off and converted into cash now rather than in the past. Marketing managers should consider inventories as working capital just as accountants do, and ask whether those stocks are being deployed most effectively.

Frequently, managers have to consider the most effective inventory policies for perishables and consumables. In restaurants particularly it is vital to control wastage of food stocks bought in anticipation of sales – a delicate balancing act between having too much and incurring higher costs and having too little and enduring lost sales and/or customer dissatisfaction.
Secondly, there are organizational credit policies to consider. Many organizations will operate using inventories bought on credit from their suppliers. This may be an effective means for raising working capital, but it may be expensive in terms of the cost of the good sold. Supplies acquired on credit might be priced higher than they would be otherwise. Does the organization pay a premium for the easy credit it enjoys? Similarly an organization may offer credit terms to its own customers as a means for stimulating sales. The benefits of increased sales revenues will be reduced somewhat by higher costs of providing credit as well as the cost of the capital used. For example, an organization may sell blocks of its capacity to other organizations at a lower price and with payment due later; as distinguished from sales made to individual customers more irregularly at higher prices and paid for at the time ordered or when the services are delivered. A number of managerial issues arise in these situations.

The working capital employed in an organization’s operations will be greatly affected by its marketing policies, and it is useful for managers to understand those effects.

A summary of adjustments is:

\[
\text{CASH} = \text{Profit} + \text{Depreciation} - \text{Change in inventory} - \text{Change in creditors} + \text{Change in debtors}
\]

The profit and loss statement shows the effect of a period’s operations on an organization. The cash flow analysis shows the effect of those operations on the organization’s working capital – the monies it relies on in its day-to-day activities.

But organizations also use buildings, equipment, patents and brands, and capital borrowed or invested for the long term. These are not working capital but are still necessary for the organization to operate. The profit and loss statement simply describes an organization’s activity within a specific period, but it existed before that, and will generally continue afterwards. The organization started the period with various assets and liabilities – these are described by the balance sheet. The balance sheet will be changed by the activities described in the profit and loss. Sales (and production) will possibly alter the organization’s inventories. These interactions between the profit and loss statement and the balance sheet are also important for management.

**Balance sheets and fixed assets used in tourism**

The distinction between fixed and current assets reflects the need to distinguish between the working capital used within the day-to-day operations and the marketing efforts of an organization and those assets used to support those operations in the longer term. For example, in a restaurant it is necessary to have both food and the equipment to process and cook it, but the food is inventory that is regularly bought and sold while the equipment remains in the organization’s possession. In marketing a similar situation arises: it may be necessary to promote the facilities or services in numerous ways – advertising, discounting, exhibitions, etc. – in the day-to-day activities of the organization but services and facilities also need to be developed.

Management focuses on strategic development of products and services, of brands and customer relationships and numerous other long-term initiatives. Without these developments of what may be considered marketing and operating assets the short-term marketing and operations will be handicapped. These longer-term developments may well have a presence seen in the financial accounts on the balance sheet (Table 10.2 describes the implications). The key issue is whether these have a measurable, marketable value. For example, an organization may purchase a franchise and have the rights to use a brand and products or services in its operations. These represent an asset. Similarly, new facility, product or service development can involve
Table 10.2. Balance sheet and implications for management.

<table>
<thead>
<tr>
<th>Balance sheet</th>
<th>Current year (£)</th>
<th>Previous year (£)</th>
<th>Implications for management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed assets (at cost less accumulated depreciation)</td>
<td>110,000</td>
<td>120,000</td>
<td>Fixed assets are the long-term capital used by the organization in the form generally of physical facilities – buildings, equipment, shop fittings, etc. Intellectual property like patents is included as are such things as acquired ‘rights’ to produce products or use a franchise. Whether a ‘brand’ constitutes a fixed asset is somewhat controversial. And the suggestion that customer relationships too are assets is one totally alien to accounting although any marketing manager would regard these as critical.</td>
</tr>
<tr>
<td>Current assets</td>
<td></td>
<td></td>
<td>The basic criterion is whether the asset will last longer than 1 year, or be fully used up or sold in less time.</td>
</tr>
<tr>
<td>Inventories</td>
<td>25,000</td>
<td>20,000</td>
<td>Inventories are goods produced and held for later sale. They may be created on purpose to decouple sales activities and production processes, or to provide an immediately available supply to support sales. There are two dimensions of particular interest for management: (i) the volume of stock available; and (ii) the variety of stock available. The balance sheet simply shows the total value and a disaggregated view may be more useful. One useful relationship is inventory turnover (i.e. how quickly could these stocks be sold).</td>
</tr>
<tr>
<td>Creditors (less bad-debt allowance)</td>
<td>15,000</td>
<td>10,000</td>
<td>Creditors are customers who have bought on credit and this reflects the monies owed to the organization. Credit policies may be a critical issue in supporting sales, with ‘loose’ credit stimulating sales. Such policies have associated cost: (i) the opportunity cost of the monies so lent (they could be deposited in a bank and earning interest); and (ii) a cost is the possibility of non-payment (bad debt). Sales made to larger organizations may suffer from significant delays in payment, so close control of the creditors’ turnover period can be important.</td>
</tr>
<tr>
<td>Cash and securities</td>
<td>2,000</td>
<td>2,000</td>
<td>These funds are almost immediately available to settle the organization’s own debts and liabilities.</td>
</tr>
</tbody>
</table>
Table 10.2. Continued.

<table>
<thead>
<tr>
<th>Balance sheet</th>
<th>Current year (£)</th>
<th>Previous year (£)</th>
<th>Implications for management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total assets</td>
<td>152,000</td>
<td>150,000</td>
<td></td>
</tr>
<tr>
<td>Liabilities</td>
<td></td>
<td></td>
<td>Current liabilities are those that will demand payment within 1 year – long-term liabilities are those that do not have to be paid that quickly.</td>
</tr>
<tr>
<td>Current portion of long-term debt</td>
<td>6,000</td>
<td>6,000</td>
<td>While the bulk of long-term liabilities do not require payment in the current year there is usually some obligation to service the debt by making periodic payments on the debt. This figure represents the amounts due in the current period.</td>
</tr>
<tr>
<td>Debtors</td>
<td>12,000</td>
<td>10,000</td>
<td>The organization may have bought on credit itself. This represents the amounts owed. This may be of some interest to marketing if the credit taken on purchases is reflected in higher purchase costs that will be reflected in higher cost of goods sold in the profit and loss and lower profits.</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>20,000</td>
<td>22,000</td>
<td>This is the outstanding balance of the long-term debt excluding the portion currently payable. The long-term debt represents borrowings and reflects the organization's financial strategy – whether to use debt or equity in funding its operations. Debt incurs fixed payments while equity does not.</td>
</tr>
<tr>
<td>Share capital</td>
<td>100,000</td>
<td>100,000</td>
<td>Organizations typically have shareholders who have invested. The share capital describes the sums of money so invested.</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>14,000</td>
<td>12,000</td>
<td>Retained earnings are profits earned in previous periods that have been kept by the organization for its own investments and to support its future activities. Such profits could have been paid to the shareholders as dividends, but most organizations find that keeping these for re-investment is more effective than having to raise new equity funding or borrowing.</td>
</tr>
<tr>
<td>Total liabilities and equity</td>
<td>152,000</td>
<td>150,000</td>
<td></td>
</tr>
</tbody>
</table>
expenditure over several years to yield an asset that may then be exploited. This expenditure will often be treated as an expense in the period it is made – there are significant tax benefits in doing so as this effectively shields current profits from taxation. These expenditures may yield later profit streams, so they are in actuality investments.

Similarly, many marketing efforts create brand identities through effort and expenditure over periods of time. These may also be considered to represent an ‘asset’ in providing an economically exploitable identity. But valuing such expenditure as an investment is difficult: how can a distinction be made between advertising that promotes current sales and its lingering effect in helping future sales? How can such costs be allocated – for the implication is that some of these costs should really be spread over the whole time horizon for which they help sales. If so, then these residual effects need some consideration as an asset just as any other that depreciates over time.

Similarly, many operational activities can promote a particular image and market presence. Consider the role of quality in an organization’s image. Relatively small costs in the area of consumables can create disproportionate impressions in the perceived quality of the services offered; as can operational policies such as maintenance that keep a facility at its best appearance, contributing to an image of quality.

Balance sheets are excellent at representing things on the basis of their cost. They are less effective at presenting things in terms of their value. An asset may be carried on the balance sheet on the basis of its purchase price less depreciation, but it may be obsolete and have no monetary value; conversely, another asset may be fully depreciated and thus have no value shown on the balance sheet, yet still be useful for generating income and have value on that basis. This may be true for all the fixed assets of an organization: they are shown on the books at cost less depreciation, yet the company keeps them because it believes they can all be exploited to yield greater income now and through their life than if sold off.

Many of the intangible dimensions of marketing – building brand identity, customer relationships, etc. and such things as staff skills and loyalty – are almost impossible to effectively value in the first instance. And these can prove even more difficult to convert into a marketable form – how can a customer relationship be ‘sold’ to another party to realize its value? Should the organization go into liquidation? Thus, many of the financial interests involved create intangibles difficult in the first instance to monetarily value; and impossible to render into a marketable form even if values may be determined. It might be useful nevertheless to think of a ‘balance sheet’ in which such intangibles have a presence. This cannot replace the true financial balance sheet but ought to serve a parallel purpose – to formally and honestly assess the long-term marketing ‘investments’ that may be considered assets for any organization.

While a brand may not show up on a financial balance sheet it may on one used for marketing. However, this forces a number of difficult and potentially unwelcome questions to be confronted, such as: Is this to be valued at cost, or should its exploitable market value be used? Most would argue that some idea of the present value of future benefits should be used but these may not be readily expressed monetarily.

**CONCLUSIONS AND SUMMARY**

This chapter has presented a perspective on accounting that reveals the financial consequences of common marketing decisions and policies. No marketing manager can ignore the economic effects of their decisions and actions and a better understanding of those should improve both decision making and performance. The chief focus is usually on the profit and loss statement.
because it reflects sales activities directly and marketing strategy and planning more generally. Simple, but important developments like sales revenues and costs can be measured and potential problems recognized. Financial analysis will not provide a solution, but it is a vital tool in identifying symptoms of problems and suggesting avenues for investigation. Relationships too can be recognized—trends in sales or the impact of credit policies on sales. The underlying need to justify marketing decisions and actions in terms of profitability or cost-effectiveness makes a grasp of these relationships most useful.

This has been achieved through the chapter’s discussions of:

- the accounting systems reports and their relevance to specific needs;
- analysis of the profit and loss statement and the effects that management actions may have on various elements reported in them;
- analysis of the balance sheet and its relevance for tourism managers; and
- analysis of the differences between profit and cash flow and the effects of various management decisions on cash flows.

FURTHER READING