**TRAINING IN FINANCIAL AND BUSINESS MANAGEMENT FOR ROAD CONTRACTORS**

**MODULE TWO SESSION SIX PARTICIPANTS’ NOTES**

**DEMONSTRATION OF EFFECT OF VARYING STRATEGY**

**1. Session Objectives:**

* 1. Enable participants to make decisions based on evaluation of differing financing and management options.
	2. Demonstrating the effect of managerial decisions on profitability and cash flow in areas of credit, asset acquisition, drawings, margins and borrowing**.**
1. **Business planning in a changing environment**

Business planning is looking ahead and keeping the business ahead of competition. Since business environment is continually changing, management should continually predict the impact of a changing strategy on overall profits and cash position.

Investors may want to test all scenarios in order to make decisions to finance or to invest. While trying out different scenarios, care should be taken to distinguish between the fixed and variable costs. Fixed costs will remain fixed even when revenue grows or drops for instance office rent, site rent and administration salaries may remain the same even when business is low. Variable costs include gravel where the volume and cost may depend on road length contracted. While planning, reduce fixed costs to a bare minimum; they will strain the business if business activity drops abruptly.

1. **Changing strategy impact on profits**

The income statement is a standard measuring tool used to convey projected profits basing on projected revenues and expenses. These projections may be short term and long term. Both short term and long term income statements will be affected by the assumptions and decisions made by management. For example, profits will be affected by the pricing policy. On the face of it a higher profit margin will increase profitability; however the increased margin may reduce the volume of business available to the company. Secondly the capital structure chosen as well as whether to purchase or hire machinery may also affect profitability. Income statement projections include estimates of how much money the company plans to borrow and interest repayments on those loans will affect profits.

When projecting growth, consider the state of the current construction market environment in which the company is operating, as well as trends in raw material and labour costs.

Using spread sheets you could analyze the impact the following will have on profitability of Munaku’s business from the case study.

* 1. Hiring all the equipment
	2. Varying the margin from say 30% to 20% ( ignoring the price limitation)
	3. Increasing the wage rate by 10%

You will notice that it is fairly easy to alter the targeted profits on paper. The challenge is to control actual performance to ensure that the projected profits are actually realized. In practice we have to be very careful because some decisions made during the planning process may be difficult to reverse. For example, where salary rates are increased in anticipation of higher business volume, if the turnover is not realized the business will be stuck with the high wage bill and may even realize lower profits than before. So when proposals are made to increase profitability, you should ensure that such scenarios are as near reality as possible.

1. **Impact of changing strategy on cash flow**

To run a business in road construction effectively, there is a need to balance the timing and amount of costs with revenues. The long term cash flow will assist greatly in the balancing of the timing for major expenditure as well as the viability of such spending. Managing the cash flows is important for the growth and survival of any business. Cash flow forecast helps to plan spending and assess potential risks in cash flow due to any changed circumstance. The demonstration will show how important the forecast is and how vulnerable it is to assumptions and financial decisions such as investing in capital assets, credit periods and gearing.

Cash flow will greatly be strained by acquisition of capital assets and as much as possible such assets should specifically be financed with long term capital in form of equity or debt. Similarly increase in capacity will be followed by increased working capital such as inventory and work in progress. Appropriate funds should be retained in the business to meet this challenge. A well-developed cash flow will bring out these salient features.

There are also decisions that will result in accumulation of cash over the planning period particularly where lucrative contracts with good payment records are obtained. The cash flow forecast will indicate such phenomenon. If the build-up is for a short time, short term investments such as term deposits or treasury bills should be considered.

 If the build-up extends over long periods, more permanent investments should be considered such as purchase of capital items, expansion or diversification of the business. The business should plan to invest in capital items only when long term build up for cash is anticipated.

**5. Group Assignments**

Using the cash flow plan prepared earlier, test the impact of the following on cash flows.

1. Comparison of Income Statement and Cash Flow Projections.
2. If the price limit of shs. 450m/kms did not apply
3. Taking no drawings per month.
4. Certified work paid for after two months instead of one.
5. Deferring the land purchase and hiring all the equipment instead of buying it (assume additional rental per month of shs. 6m).
6. Buying materials and fuel and hiring equipment on credit of one month.
7. Deferring purchase of land and equipment and hiring it at an extra 6m per month, taking no drawings and purchasing material and fuel at 30 days credit.
8. A 20% margin on cost without the price limit of shs 450m, certification done monthly and paid for after 30 days, deferring purchase of land and equipment and hiring it at an extra 6m per month, taking no drawings and purchasing material and fuel at 30 days credit.