Review Unit 3

29. Otter Mountain Theater SL

A. Define the term overdrafts.	2

A withdrawal from a bank account above and beyond the balance in the account, in return for a fee and typically a high interest rate.

B. With reference to OMT, distinguish between capital and revenue expenditure.	4

Capital expenditures is the purchase of fixed assets, which in OMT's case could be spending on their own building, or other purchases like computer systems, equipment for set building, or really any asset that's going to last them more than a year. Revenue expenditure is spending on day to day operating expenses rather than fixed asset. For OMT these can include advertising expenses, wages and salaries, and so on.

C. Explain two reasons why OMT's additional financing options may be limited due to its non-profit social enterprise status.	4

Answers may include, but are not limited to:

- They can't issue shares as a nonprofit
- Their ability to get a bank loan could be lower than a for-profit because

D. Define the term overheads.	2

Indirect costs that are not attributable to any one project, division, or product line but are nevertheless incurred for the business to function.

E. Calculate the value of OMT's gross profit in each of the two financial years shown.	2

Prior financial year:
(906+580-91.5)/(906+580) = 0.9384253 = 93.84%

Latest financial year
(809+455-98.1)/(809+455) = 0.92238924 = 92.24%

F. Calculate OMT's profit margin in each of the two financial years shown.	2

Prior financial year:
(906+580-91.5-899-12.8-67-168)/(906+580) = 0.1666891 = 16.67%

Latest financial year
(809+455-98.1-852-104-84-294)/(809+455) = -0.13299051 = -13.30%

G. Comment on two aspects of OMT's financial performance that can be seen in the case study given.	4

Answers may include, but are not limited to:

- GPM is holding relatively steady, which makes sense because it does not seem that cost of goods sold is a major portion of this organization's costs. It doesn't produce a tangible product (at least as its main revenue source - it may sell things like gift mugs, shirts, etc.), so GPM is pretty high both years.
- Profit margin is down sharply, and they experienced a large loss in in the latest year
- Their current ratio is actually improving, so they're holding enough cash on hand.
  SL: However, given the fact that they are said to be heavily in debt, an ESL student should be able to see that they're funding their current assets through long term liabilities at least to a pretty large extent.
  HL: Should be able to see that the gearing ratio is quite high in both years, and rises quite a lot in the latest year. This is a firm that is definitely debt burdened in relation to its sales.
- They're spending more on overheads, and in consulting fees in particular in the second year. None of the expenses except for salaries and wages are going in the right direction,a dn this is particularly troublesome considering that their revenue declined massively in the second year.

H. In addition to what is mentioned in the case study, explain two additional revenue streams that may be possible for OMT.	4

Answers may include, but are not limited to the following:

- They could sell acting classes
- Sales of physical items and gifts, similar to what Amy is planning with the crowdfunding
- Gift cards
- Any kind of premium experiences like a VIP gathering/party with food or meet and greet session with actors and such before or after a performance
- They could possibly put on smaller performances outside the theater for events or groups
- Service fees on ticket sales

I. Explain two challenges in OMT improving its profit margin.	4

Answers may include, but are not limited to the following:

- As a nonprofit that has some paid actors it is reasonably professional, but probably not up to the standards of an entirely for-profit theater organization, and so it would probably be challenging to charge higher ticket prices.
- It's probably also hard to charge higher ticket prices due to news reports that the organization is heavily in debt and the director resigned; customers may feel like the org has been mismanaged.
- It's hard to cut staff and other costs without sacrificing the quality of the performances or the org's ability to operate in other ways.
- It is heavily reliant on debt as it is and things look unsustainable, so it's very hard for it to make long term investments that would improve the profitability in the long run
- A lot of their funding comes from donations and government funding, unrelated to their direct trade related revenue, so even if they put on a series of good performances, they may not be able to make that translate to increased funding from either of these 2 sources.
- The government is unlikely to approve the new loan, and they're probably upset about

mismanagement, so it could be hard to convince them to pour more money into the org that would act as income (as opposed to a loan, which is not income).

J. Explain what an increase in OMT's long term loans will do to its return on capital employed (ROCE), if all else is held equal.	2

The return on capital employed is a ratio of profits before tax/interest to net assets and long term liabilities. Thus, if the long term loans increased it would increase the denominator of the equation, making the ROCE percentage decline. A student may state that a loan could increase its ability to make profits, but this question specifically says that we're holding all else equal.

K. Explain one way in which OMT could attempt to improve its working capital cycle, and one drawback to that method.	4

Answers may include, but are not limited to the following:

- The most fundamental thing that it needs to do is shorten the time it takes to put on a performance, because it incurs costs during the preparation and rehearsal phase. It's really hard to shorten this time period though because this theater is not fully professional, and even if it was, there's a lot to this art form that can't just be easily sped up.
- It may try to sell more tickets in advance, especially since people generally want to know they have tickets well ahead of time rather than trying to buy them close to the show date. OMT could even offer discounts on early purchases if need be, or try to sell more subscriptions to gain additional cash flow. Right now though it may be hard to convince people to buy tickets when they're not even sure the show will be performed, and even in normal circumstances it could be hard to convince enough people to buy early enough for when OMT needs the cash to pay off its production costs.
- They could negotiate longer trade credit terms with suppliers of equipment, set materials, costumes, scripts, and so on. However, this is often not possible, and because they're a small organization, they don't have a ton of bargaining power most likely.
- They're spending an awful lot of money on advertising and consulting, especially when we view the consulting fees in relation to the prior year. A lot of this probably *needs* to be cut, as it may represent spending that is related to mismanagement and operations that could/should be conducted in-house by OMT staff. In practice though, they may be getting a lot of valuable help from marketing firms and consultants and would be unable to replicate the high quality of work on their own.

M. Discuss the challenges in OMT obtaining sustainable external financing to improve its ability to function.	10

Answers may include, but are not limited to the following:

Reasons why obtaining suitable finance may be challenging:

- It's stated that the city council is unlikely to approve the loan, and that even if they do it will come with stringent requirements on OMT. Even if they get the loan, there may be oversight requirements that they feel makes it too challenging for them to operate the way that they need to.
- Sales are declining, and thus it may be harder to convince either the government to extend a loan in these circumstances, to get overdrafts on reasonable terms (or at all) from the

bank, or to convince people to support them with donations/crowdfunding
- They can't even get the scripts to their next play right now, meaning that they can't easily convince people that there will even be a next performance and thus that this is an organization that should be funded.
- They already have "shocking" amounts of debt (and HL students will notice the extremely high gearing ratio), and it's harder to get funding from any source when it's already been reported that they've been mismanaged and have high debt levels.
- They're spending what seems to be absurd amounts of money on consulting - again, why would someone want to extend more financing to OMT without serious cost controls?

Reasons why obtaining suitable finance may be a management challenge:
- They're a nonprofit organization that's been around for a very long time and has a good track record of performances; there may be plenty of people who are willing to crowdfund this organization through Amy's planned sales methods or through simple donations.
- The theater is likely a good selling point for local tourism and just the quality of life in the city, and so the city council may want to do what is necessary (within reason) to prevent them from failing.
- It does at least have a decent current ratio, I guess...so maybe that gives them a buffer to be able to pay off overdrafts and convince a bank to let them take out an overdraft for a reasonable fee.
- The case study says that personal donations are increasing, and so if that's true and yet that line item in the financial data actually went down, then it must mean that government funding declined in relation to donations. The government then may be willing to extend a loan as it sees OMT is getting better at other fundraising methods.

O. Given the variance, calculate the originally budgeted figure for advertising.	1

84000-29000 = $55000

P. Other than advertising, state one other item that would be shown on OMT's budget if it followed the standard format.	1

Answers may include:
- Sales revenue
- Interest earned
- Salaries and wages
- Materials
- Rent
- Electricity