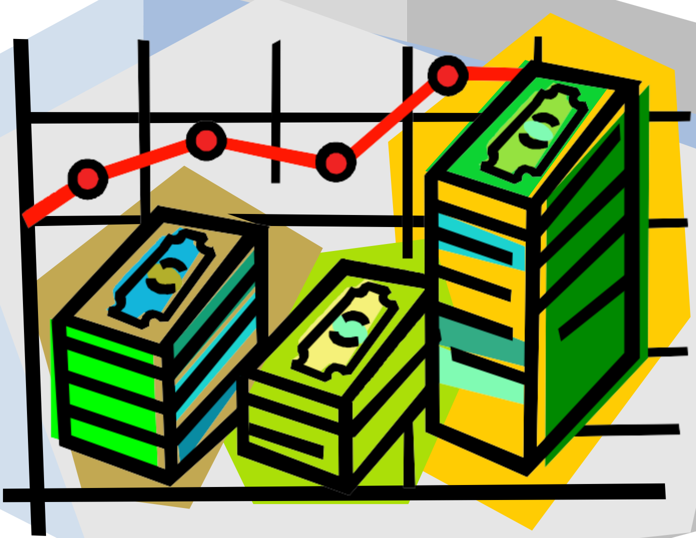
Business Management

N5

Management of People and Finance

3.2 – Finance



Learner's Notes

Introduction

In this topic you will find out about the following things.

Sources of finance	• *APPROPRIATE TO:*
	  o *Sole Trader*
	  o *Partnerships*
	  o *Private Limited Companies*
	  o *Public Sector businesses*
	  o *Third Sector Businesses*

Cash budgeting	• *INTERPRETATION OF CASH BUDGETS* • *CASH FLOW ISSUES* • *CASH FLOW ISSUE SOLUTIONS*
Break even	• *TYPES OF COSTS* • *PROFIT* • *BREAK-EVEN POINT*
Profit statement	• *SALES* • *PRODUCTION COSTS* • *GROSS PROFIT* • *NET PROFIT*
Technology	• *ROLE OF TECHNOLOGY IN MANAGING FINANCE*

WHAT IS FINANCE ALL ABOUT?

> *The role of **FINANCE** in a business is to make sure that a business has enough **CASH** to keep going and to produce **FINANCIAL DOCUMENTS** that will help it to plan and record its' financial performance.*

The main activities that are involved in this work by Finance staff are as follows.

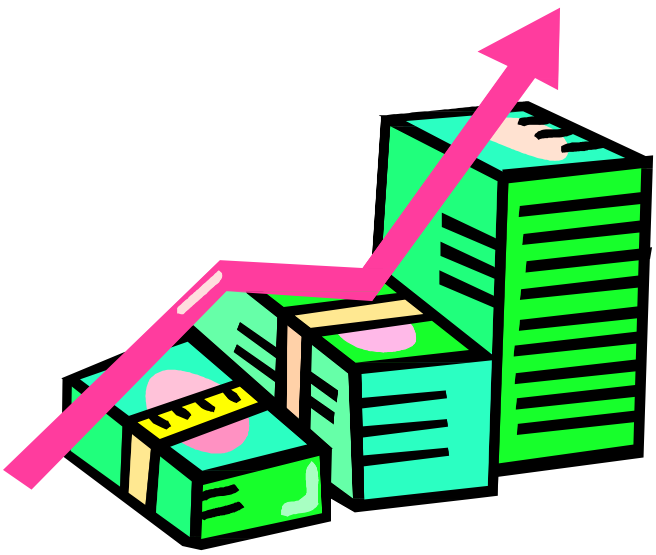
- *RAISING FINANCE FOR BUSINESS ACTIVITIES*
- *DEALING WITH PAYMENTS RECEIVED*
- *PAYING FOR BUSINESS ACTIVITIES*
- *MANAGING CASHFLOW*
- *CALCULATING AND MONITORING PROFIT*
- *BREAKEVEN ANALYSIS*

This work by the Finance staff is very important to any kind of business in an economy (ie PRIVATE, PUBLIC or THIRD sector), because if it is done properly then it can bring the following benefits.

1 IMPROVED BUSINESS PERFORMANCE

This work by the Finance Department is very important to a business, because if it is done properly then it can bring the following benefits.

- *INCREASE IN MONEY AVAILABLE FOR MARKETING, HRM AND OPERATIONS ACTIVITIES*
- *BETTER BUSINESS PERFORMANCE (from effective marketing, HRM and operations activities)*
- *POSITIVE BUSINESS IMAGE (from effective marketing, HRM and operations activities)*
- *INCREASED CONSUMER SATISFACTION (from effective marketing, HRM and operations activities)*
- *INCREASED USE OF THE BUSINESS BY CONSUMERS (CONSUMER LOYALTY)*



2 PREVENTS BUSINESS FAILURE

If a business runs out of money for paying bills and supporting the activities of Marketing, Operation and HRM, then it will have to close and will have **FAILED**. The following things will then happen to end the business.

People owed money by the business go to court to try and get their money back.

↓

The court puts the business that cannot pay bills into **ADMINISTRATION** (the legal process of the business trying to get money to pay those owed). When this happens, the court can put an **ADMINISTRATOR** in charge of the business instead of the normal management.

↓

The administrator will try to change the way the business is managed in order to raise enough money to pay off its debts. The administrator may try to get someone to buy the whole business, pay off its debts and carry on its' work with new owners. This is known as selling the business as a **GOING CONCERN**. If either of these actions work the business will come out of administration and be allowed to run with its' own managers again.

↓

If the business pay back its debts (because it cannot be changed to run in a profitable way or sold as a going concern) then the **ASSETS** of the business and any unlimited owners will be sold to get cash which will be used to repay (some or all) of the debts of the business. This break up and sale of the business in parts is known as **LIQUIDATION**.

This means that the work by the Finance Department is very important to a business, because if it is done properly then it will make sure that the business **DOES NOT FAIL** because it will have enough financial information and money to operate effectively and pay its' bills.

RAISING FINANCE FOR BUSINESS ACTIVITIES

All businesses need FINANCE (money) to pay for the following items or it will simply be unable to start up, expand or continue its' activities.

- *PURCHASE OR USE OF PREMISES*
- *PURCHASE OR USE OF CAPITAL*
- *USE OF LABOUR*
- *USE OF ENTERPRISE*
- *BUSINESS GROWTH AND EXPANSION*
- *GENERAL RUNNING COSTS (eg electricity, raw materials, insurance, etc)*

The details of the 2 main sources of finance that are available to small to medium sized businesses in order to make these payments can be seen over the next few pages.

1 INTERNAL FINANCE

Internal finance is money that comes from **INSIDE** of the business itself. The main types of internal finance for small and medium businesses are as follows.

Finance	Description	Available for how long?	Available to whom?
CAPITAL 	Capital is the money invested in a business by an owner. This is **EQUITY** finance. This means that providing this type of finance results in some ownership and control of the business in return.	Until the owner closes the business or takes the money back.	• *SOLE TRADER* • *PARTNERSHIP* • *SOCIAL ENTERPRISE*
ORDINARY Shares 	These are company shares that provide their shareholders with a **VARIABLE DIVIDEND** (share of profit) based on available profits. This is **EQUITY** finance and allows a say in running the company.	Until the owner closes the business down.	• *PRIVATE COMPANY*
PREFERENCE Shares 	These are company shares that provide their shareholders with a **FIXED DIVIDEND** of any profit, before **ORDINARY** dividends are paid. This is **EQUITY** finance, but **DOES NOT** always allows a say in running the company.	Until the owner closes the business down.	• *PRIVATE COMPANY*
PROFITS 	Profits that have been made by businesses (and have not yet been spent or given to owners) can be used to pay for things.	Until the owner closes the business or uses it up.	• *SOLE TRADER* • *PARTNERSHIP* • *PRIVATE COMPANY* • *SOCIAL ENTERPRISE*
GOVERNMENT BUDGET 	The Government's budget provides an amount of money (raised from taxes, etc) that is given to managers of Public Sector businesses to fund their activities.	VARIABLE (depends on expected life of service)	• *PUBLIC SERVICES*

The main **ADVANTAGES** of using **INTERNAL** finance include the following.

- *Internal finance does NOT usually need to be repaid. This means that a business will be able to maximise revenue or profit as it does not have repayment and interest costs.*
- *Internal finance does NOT usually need to be repaid. This means that a business does not have any obligations to repayments which may make it fail if they are not made.*
- *Internal finance does NOT usually need to be repaid. This means that a business knows that it can rely on this money and so can plan for the future more effectively.*
- *Internal finance does not normally need to get approval about its use from people outside of the business (eg bank). This can make the business easier to run as this finance can usually be used in whatever manner the business likes.*

The main **DRAWBACKS** of **INTERNAL** finance include the following.

- *Use of equity sources of internal finance can decrease the returns to each owner of a business. For example, if a business uses up profits as finance then it will not be available for the owners to draw from the business. This will also happen if more shares are issued because the same amount of profit will now be split between more owners. For example, if the was £100 profit and 100 owners then they would each be entitled to £1. However, if 100 more shares were issued then each owner would only now get 50p(£100/200).*
- *Use of equity sources of internal finance can decrease the control of each owner of a business. For example, if a 2 person equal partnership becomes a 3 person equal partnership then control will change from 50% for each partner to 33% for each partner.*
- *Internal finance is usually only available in limited amounts. This can mean that it cannot be used for everything that a business wants to do and so external sources may need to be accessed.*

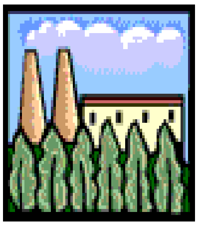
2 EXTERNAL FINANCE

External finance is money that comes from someone **OUTSIDE** of the business. Examples of these external providers of finance include:

- *COMMERCIAL BANKS (these are banks that deal with individuals and businesses eg Royal Bank)*
- *MERCHANT BANKS (these are banks that only deal with businesses)*
- *PENSION AND INSURANCE COMPANIES (they invest money to create profits for themselves)*
- *GOVERNMENT ORGANISATIONS*

External finance is made available from these providers in various forms and amounts. This finance is also differentiated by the period of time that it is made available – **SHORT**, **MEDIUM** and **LONG TERM**.

Common types of **LONG TERM EXTERNAL FINANCE** for small and medium businesses are as follows.

Finance	Description	Available for how long?	Available to whom?
MORTGAGE 	This is a specific type of loan to buy **PROPERTY**, eg factory. Mortgages must be repaid with **INTEREST**. Mortgages are **SECURED** loans – this means that the debt is linked to the property bought and it can be taken and sold to get any unpaid money back. However, despite this, mortgages are **NOT** equity finance.	LONG TERM (10+ years)	• *ALL BUSINESSES*
SALE AND LEASEBACK 	If a business owns an asset by paying for them in full (eg premises), then it could sell the asset and then rent it back. This allows the business to still use the asset but raise finance by releasing the cash tied up in it.	LONG TERM (10+ years)	• *ALL BUSINESSES*
VENTURE CAPITALIST 	Here part of the business is sold to a **VENTURE CAPITALIST**. This is an outside party who invests in businesses to make money though DIVIDENDS and then selling their share later for profit. This is **EQUITY** capital.	LONG TERM (10+ years)	• *SOLE TRADER* • *PARTNERSHIP* • *PRIVATE COMPANY*

Common types of **MEDIUM TERM EXTERNAL FINANCE** for small and medium businesses are as follows.

Finance	Description	Available for how long?	Available to whom?
LOAN 	This is money that is given which has to be repaid with **INTEREST**. Loans are **NOT** equity finance. Loans can be **SECURED** which means they asset they are used to buy can be taken if repayments are not made.	MEDIUM TERM (1-10 years)	• *ALL BUSINESSES*
HIRE PURCHASE 	Here the business buys an asset (eg van) by paying the purchase price and interest over a period of time. The business looks after and uses the asset while it is paying for it and will own it after the final payment. This means that the business does not need all the money for the asset at once and can use it to create revenue to make its' repayments.	MEDIUM TERM (1-10 years)	• *ALL BUSINESSES*
LEASE 	Here the business uses an asset (eg van) by making a rental payment. Here even though the business is paying for the use of the asset, it will **NEVER** own it. However, rented assets will be repaired and upgraded by their owner rather than the business itself which can save money and allow easy access to updated assets.	MEDIUM TERM (1-10 years)	• *ALL BUSINESSES*
GRANTS 	Here the business receives a sum of money that **DOES NOT** have to be repaid. This is often from a Government or charitable body (eg Prince's Trust) which is looking to support businesses is particular areas or markets.	MEDIUM TERM (1-10 years)	• *ALL BUSINESSES*

Common types of **SHORT TERM EXTERNAL FINANCE** available to small and medium businesses are as follows. However, it should be noted that any businesses which have to often rely on these short term methods of finance are likely to be suffering cash flow problems and so may be close to failing.

Finance	Description	Available for how long?	Available to whom?
OVERDRAFT 	This is a small loan that allows a business to spend more money than it has in its bank account. Overdrafts are automatically repaid as soon as money is paid into the bank and so a business will not be able to choose how much to repay at any time.	SHORT TERM (<1 year)	• *ALL BUSINESSES*
DEBT FACTORING 	Here the business sells debts people owe it to a collection company. This gives the business most of the money that it is owed all at once. The collection company is happy to do this as they will make a profit by charging interest on the debts due.	SHORT TERM (<1 year)	• *ALL BUSINESSES*
TRADE CREDIT 	Here the business tries to get people who owe money to pay quickly while the business itself takes as much **CREDIT** as it can get. This can provide some cash as money is coming in from people paying but it not having to be spent on repayments straight away.	SHORT TERM (<1 year)	• *ALL BUSINESSES*

The main **ADVANTAGES** of using **EXTERNAL** finance are as follows.

- *There are many different sources and types of external finance which can be used to provide quick access to large amounts of money. This can mean that a business will be able to develop more quickly as it does not have to wait until they have enough of their own money to pay for what they want to do.*

- *Use of external finance can increase the revenue and profits of a business. This can happen because external finance allows a business to buy and use revenue generating assets immediately rather than having to wait until enough internal finance becomes available in the future.*

- *Use of external finance usually does not affect the running of the business. This is because most external finance is not equity finance and so does not usually give providers a say in the running of the business.*

However, using **EXTERNAL** finance can have the following **DRAWBACKS**.

- *External finance normally requires payment to the lender (usually the amount used plus extra interest charges). This means that a business will have to lose some revenue or profit to make these repayments.*

- *External finance normally requires payment to the lender (usually the amount used plus extra interest charges). This means that the owners of a business will experience lower returns from it because the business will have to lose some revenue or profit to make repayments.*

- *External finance normally requires payment to the lender (usually the amount used plus extra interest charges). This means that a business now has an obligation to make these repayments or it can fail if they are not made.*

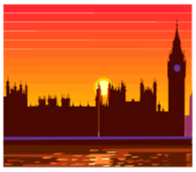
- *Securing external finance will involve the lender investigating the business and deciding if it is worth lending to because it is likely to make its' repayments. This can delay and complicate getting access to finance which can result in a lack of progress for the business.*

- *Securing external finance will involve the lender investigating the business and deciding if it is worth lending to because it is likely to make its' repayments. This can mean that a business may not get the finance that it need and so it may fail because of the decisions of other people.*

The factors which are likely to influence decisions about the **AMOUNT** and **TYPE** of finance that is used in a business can be seen below.

Factor	Description
COST 	Businesses will want to minimise the cost of any source of finance that they use. This generally means that internal finance is preferred. However, when this is not available, most businesses will want to use external finance with low interest rates.
TIME PERIOD 	Different methods of finance are available for different periods of time. Therefore, businesses should choose a method that suits the time period they need it for in order to help minimise costs. For example a business would not choose a loan instead of an overdraft to cover a small payment that would be repaid soon because this would commit them to interest payments for a longer period of time than necessary.
EQUITY 	Equity finance provides a share of ownership and so businesses will have to carefully consider how this will impact on control and returns for owners before deciding to use it.
BUSINESS TYPE 	Some businesses simply do not have access to particular types of finance due the type of business that they are. For example, sole traders cannot issue shares.

To help businesses make sure that the critical decision about the sources of finance that they are using is correct, they may wish to take advice (and perhaps finance) from organisations that have been set up to help and support them. Examples of these organisations can be seen below.

<table>
<tr><th>Organisation</th><th>Description</th></tr>
<tr><td>UK GOVERNMENT
</td><td>The UK Government has several agencies (eg regeneration agencies) which aim to offer businesses advice and support in securing finance and managing other aspects of their work.</td></tr>
<tr><td>EUROPEAN UNION
</td><td>The European Union offers the following support to businesses in order to help them with access to finance and so aid their development.

EUROPEAN REGIONAL DEVELOPMENT FUND (ERDF)
The ERDF aims to promote regional development by contributing towards the FINANCING of businesses which are working towards the following objectives.

development of outermost regions (eg remote, sparsely populated)
modernising/diversifying economic structures
creating modern and sustainable jobs
innovation and knowledge economy
environmental protection activities
developing access to transport and telecommunications

EUROPEAN SOCIAL FUND (ESF)
The ESF aims to promote regional development by contributing towards TRAINING COSTS of businesses who are involved in the following activities.

Improving access to employment and sustainability
Increasing the adaptability of workers and entrepreneurs
Improving the social inclusion of less-favoured persons

</td></tr>
<tr><td>SUPPORT AGENCIES
Prince's Trust</td><td>Support agencies exist to specifically offer support and finance to specific groups of businesses. For example, the Prince's Trust offers training, advice and grants to help young people (usually aged 16-25) to find work or start their own businesses.</td></tr>
<tr><td>PROFESSIONALS
</td><td>Business professionals can provide the following support to businesses in order to help them.

ADVICE ON BEST METHODS OF FINANCE (ACCOUNTANT or BANK)
ADVICE ON TERMS OF FINANCE USED AND THEIR IMPACT (LAWYER)
</td></tr>
</table>

In order to convince the above organisations that the business seeking finance is eligible for it and will able to pay it back (especially when it is just starting up), they may produce a **BUSINESS PLAN**. A business plan is a document which shows the following information about a business.

- *BUSINESS DETAILS (ie name and address, aims, business type)*
- *PRODUCT INFORMATION (ie what product will be sold)*
- *MARKET STRUCTURE INFORMATION (ie no of customers, competition)*
- *MARKETING INFORMATION (ie pricing, promotion, placement)*
- *RESOURCES REQUIRED (ie people, premises)*
- *FINANCE REQUIRED (ie type, amount)*
- *PERFORMANCE FORECASTS (ie expected sales, profits and cashflow)*

A sample business plan can be seen below.

BUSINESS PLAN

Business Details

Business Name:	Haddock Enterprises Ltd.
Business Address:	12 Fish Lane, GLASGOW, G12 2FC.
Business Type:	Private Limited Company.

Product Details

Product:	Fast Food - Fish and Chips.

Market Structure

Customers:	5,000 workers and shoppers pass premises daily.
Competition:	McDonalds (900m away) – prices are similar on average.

Marketing Information

Pricing:	£3.00 for suppers, £2.00 for singles and £1.50 for chips.
Promotion:	£2.00 suppers at lunchtimes, local paper adverts.

Resources Required

Staff:	4 part time and 2 full time staff (£4.50 per hour).
Premises:	12 Fish Lane - rent of £150 per week.
Equipment:	Frying equipment – purchase at £5,000.

Finance Required

Start up:	£5,000 of Ordinary Shares between 5 owners.
	£5,000 bank loan for purchase of frying equipment.

Forecasts

Sales:	100,000 sales per year at an average of £3.00 (see SALES BUDGET).
Profits:	£150,000 (see FORECAST PROFIT AND LOSS ACCOUNT).
Cashflow:	No problems expected (see CASH BUDGET).

DEALING WITH PAYMENTS RECEIVED

*The **DEALING WITH PAYMENTS RECEIVED** part of Finance's work is all about making sure that any money received is recorded and banked correctly.*

The business will receive money from consumers as payment for the goods and services that they have bought. This money is often known as **RECEIPTS**. Common methods of payments used to pay for things that have been bought include the following.

- *CASH*
- *CHEQUE (written instruction to a bank to make a payment)*
- *DEBIT CARD PAYMENT (an electronic transfer between bank accounts)*
- *CREDIT CARD PAYMENT (a payment by a credit card company on someone's behalf that they will have to then repay later [with interest if the full amount is not received at once]).*

When these payments are received, the Finance staff will complete the following activities to process the payment.

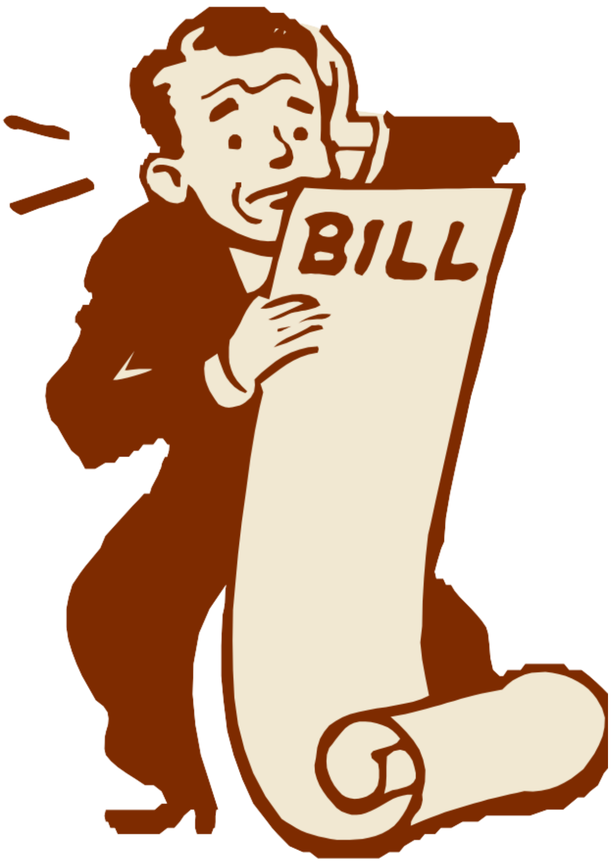
- *CHECK THAT THE AMOUNT PAID IS CORRECT*
- *RECORD THE PAYMENT*
- *DEDUCT THE PAYMENT FROM ANY BALANCE OWED*
- *ENSURE PAYMENTS ARE CORRECTLY ENTERED INTO THE SAFETY OF THE BUSINESS BANK ACCOUNT*

PAYING FOR BUSINESS ACTIVITIES

*The **PAYING FOR BUSINESS ACTIVITIES** part of Finance's work is all about preventing business failure by using finance raised and payments received to pay all of the bills of the business on time.*

The main payments that have to be made for activities that keep the business running are as follows.

- *STAFF WAGES (this is known as PAYROLL)*
- *PROFIT PAYMENTS TO OWNERS*
- *RENT OF PREMISES*
- *INSURANCE FOR PREMISES*
- *LIGHT, HEAT AND POWER FOR PREMISES*
- *PURCHASE OF RAW MATERIALS*
- *STORAGE OF STOCKS*
- *TRANSPORT OF FINISHED GOODS*
- *TAXES ON PROFITS*
- *PURCHASE OF NEW PREMISES*
- *PURCHASE OF NEW EQUIPMENT*



MANAGING CASHFLOW

*This part of Finance's work is concerned with managing the use of cash in the business so that it has a positive **CASHFLOW** and does not fail because it has run out of money.*

The **CASHFLOW** of a business refers to how the amount of cash available to the business is affected by the money coming into it (from finance and sales) and the money going out of it (as payments).

This part of Finance's work is critical in all businesses. This is because businesses need cashflow to be **POSITIVE** (which means more cash is coming on than is going out) in order to increase the overall amount of money that they have and so minimise the chance of going bust.

This work requires careful management as there are many reasons why a business could easily get into a situation which causes cashflow to become **NEGATIVE** and so increase the likelihood of business failure as it can no longer pay its' bills.

Common examples of these **CASHFLOW PROBLEMS** that can be encountered in small to medium businesses can be seen below.

- *STOCKPILING (holding lots of stock will tie up cash and so decrease the amount that can be spent)*
- *OVERTRADING (large outflows to pay for lots of production at once can mean there is little cash left)*
- *OVERINVESTMENT (large outflows to buy expensive assets can mean little cash is left over)*
- *TOO MANY CREDIT SALES (this decreases cash inflows as payments will be made at a later date)*
- *TOO MANY CREDIT PURCHASES (future cash outflows as repayments will decrease cash available then)*
- *INFLATION (inflation will make outflows to pay for business costs rise and so can decrease cash available)*
- *EMERGENCIES (this can mean quick and unexpected outflows [eg machine repair] and less cash)*
- *FALL IN DEMAND (this can cause cash inflows to drop and so a decrease in cash available)*
- *SEASONAL FACTORS (cash flow can vary and drop over time due to social or environmental factors)*

To help businesses carry out the efficient management of cashflow that is required to try to avoid the above cashflow problems, they will often regularly gather and act on information about cashflow. This can be done through preparing and using the information in a **CASH BUDGET**.

CASH BUDGET

> ***CASH BUDGETS** are documents which show whether a business is expected to have cash **SURPLUSES** (extra cash) or **DEFICITS** (lack of cash) in the **FUTURE**.*

The main parts of a Cash Budget are as follows.

- *OPENING BALANCE (the amount of cash available at start of the budget)*
- *RECEIPTS (cash that is flowing in from sales, etc)*
- *CASH AVAILABLE (total cash available during a period before payments are made)*
- *PAYMENTS (cash flowing out from bill payments, wages, etc)*
- *CLOSING BALANCE (the amount of surplus of deficit at end of each period)*

The layout and structure of a Cash Budget can be seen below.

Cash Budget for A King for Jan 2020 – Mar 2020

		£ Jan	£ Feb	£ Mar
	OPENING BALANCE	**10,000**	**5,000**	**0**
	RECEIPTS			
	Cash Sales	*5,000*	*2,500*	*2,500*
	Credit Sales	*5,000*	*2,500*	*2,500*
	Bank Loan	*10,000*	-	-
+	**TOTAL RECEIPTS**	**20,000**	**5,000**	**5,000**
=	**CASH AVAILABLE**	**30,000**	**10,000**	**5,000**
	PAYMENTS			
	Rent	*500*	*500*	*500*
	Wages	*5,000*	*5,000*	*5,000*
	Cash Purchases	*2,000*	*2,000*	*2,000*
	Credit Purchases	*2,500*	*2,500*	*2,500*
	Purchase of Equipment	*15,000*	-	-
-	**TOTAL PAYMENTS**	**25,000**	**10,000**	**10,000**
=	**CLOSING BALANCE**[1]	**5,000**	**0**	**- 5,000**

[1] The **CLOSING BALANCE** for one period in the Cash Budget will be the **OPENING BALANCE** for the next period. For example, as you end January with £5,000 cash, then you start February with £5,000 cash.

Cash budgets can help with the cashflow management of a business because they can provide advance information about what should happen to its' money in the future. This is beneficial for a business as this can mean that it is less likely to fail for the following reasons.

1 DEFICITS CAN BE PREVENTED OR DEALT WITH

Any future deficits (shortages of funds) highlighted by the Cash Budget can be avoided or dealt with before they occur by undertaking some or all of the activities below.

- *ARRANGE AN OVERDRAFT (this will provide more cash now to prevent future deficits)*
- *ARRANGE A LOANS (this will provide more cash now to prevent future deficits)*
- *SELL OFF EXCESS STOCK (this will increase cash inflows now to prevent future deficits)*
- *SELL OFF UNNECESSARY ASSETS (this will increase cash inflows now to prevent future deficits)*
- *CUT BACK ON NON ESSENTIAL INVESTMENTS (this will decrease outflows and so prevent the deficit)*
- *LOWER STAFF COSTS (deficits can be prevented by cutting cash outflows on overtime, etc)*
- *LOWER LAND COSTS (deficits can be prevented by cutting cash outflows by moving premises, etc)*
- *INCREASE SALES (deficits can be prevented by increasing cash inflows from better marketing, etc)*
- *SPEED UP DEBT REPAYMENTS (more cash becomes available now to minimise future deficits)*
- *DELAY CREDIT REPAYMENTS (this prevents cash outflows now to minimise chance of a future deficit)*

Using these activities to deal with any deficits before they actually occur is particularly important. This is because if the deficit is not prevented and actually occurs then this means that the business will NOT have enough money to pay its' bill and so is likely to fail.

2 SURPLUSES CAN BE EFFICIENTLY USED

Cash budgets can allow plans to be made about the best way and time to use any future surpluses to benefit the business. Examples of the beneficial activities that surpluses can be used for include the following.

- *SAVING CASH FOR FUTURE USE (this will be known as a RESERVE)*
- *INVESTMENTS*
- *LARGE PURCHASES (eg new machinery, etc)*

CALCULATING AND MONITORING PROFIT

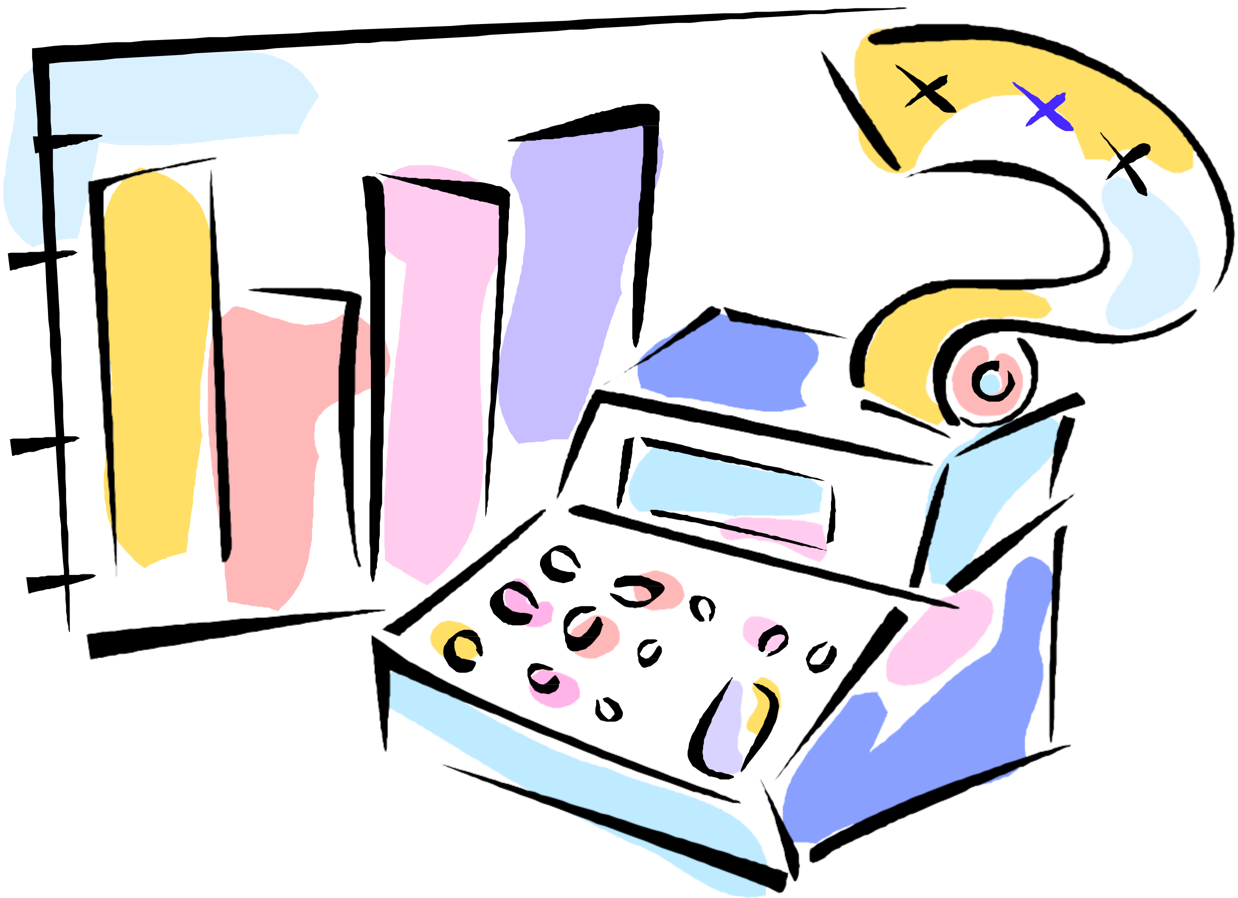
This part of Finance's work is concerned with being able to work out and record the amount of ***PROFIT*** *that an organisation is making.*

The **PROFIT** of any business[2] refers to how much extra money has been made from producing and selling a good or service. Profit is calculated as follows.

PROFIT = SALES PRICE – COST OF PRODUCTION

Profit is important to a business because it shows that they are generating wealth and cash to allow them to continue.

To help businesses efficiently monitor the amount of profit that they are making, they will usually prepare and analyse a **TRADING AND PROFIT AND LOSS ACCOUNT**.



[2] Not every business aims to make a profit (eg Government Agencies) and in this case any extra money that they generate or are left with would usually be known as a **SURPLUS**.

TRADING AND PROFIT AND LOSS ACCOUNTS

> ***TRADING AND PROFIT AND LOSS ACCOUNTS*** *are drawn up to summarise how much* ***PROFIT*** *(extra money earned) or* ***LOSS*** *(decrease in money available) a business has made during a* ***PAST*** *period of time (usually 1 year).*

This document is usually drawn up in this way to help monitor profits, but it can also be drawn up to show how much profit is expected from a specific piece of work in the future. When this happens the document would usually be known as a **PROFIT STATEMENT** or **JOB COST STATEMENT**.

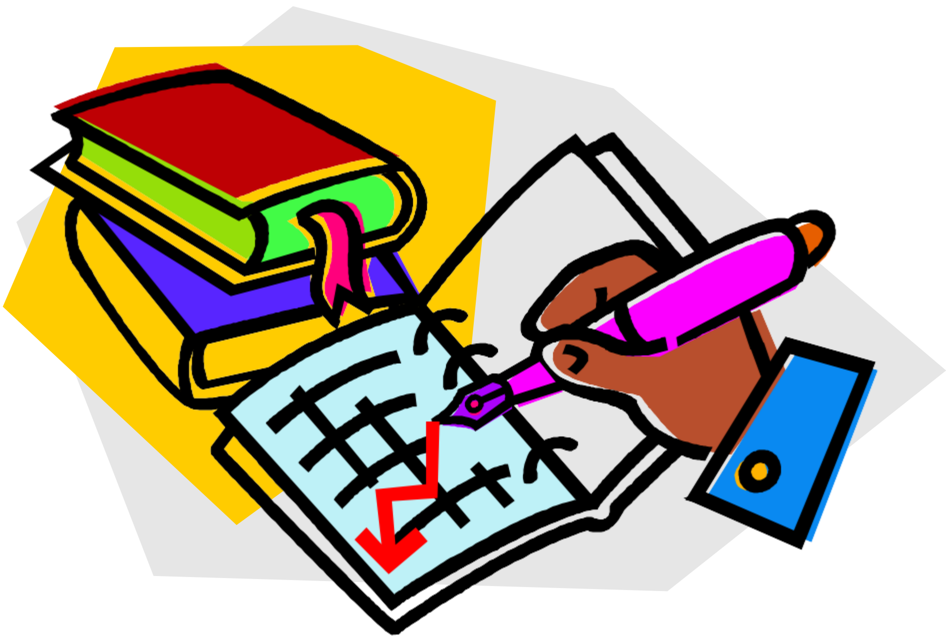
The main parts of a Trading, Profit and Loss Account are as follows[3].

- *TRADING ACCOUNT*

  This calculates **GROSS PROFIT** (overall amount of money made from **JUST** buying and selling products). It is calculated by subtracting **COST OF SALES** (costs involved in purchasing or manufacturing the products that were sold) from **SALES**.

- *PROFIT AND LOSS ACCOUNT*

  This shows **NET PROFIT** (final amount of money left for owners after paying all other **EXPENSES** [running costs]). It is calculated by subtracting **EXPENSES** from **GROSS PROFIT**.



[3] If a business has more than one owner (eg a partnership or limited company) then there is another part of this document called an **APPROPRIATION ACCOUNT**. This shows how Net Profit is shared between all of the various owners.

The layout and structure of a typical Trading, Profit and Loss Account for many small to medium businesses can be seen below.

Trading Profit and Loss Accounts for A King for the year ended 31 December 2020

		£	£	
	SALES		**100,000**	Trading A/c
	Opening Stock	*5,000*		
(+)	*Purchases*	*50,000*		
		55,000		
(-)	*Closing Stock*	*15,000*		
-	**COST OF SALES**		**40,000**	
=	**GROSS PROFIT**		**60,000**	
	Wages	*20,000*		Profit and Loss A/c
	Rent	*5,000*		
	Rates	*1,000*		
	Advertising	*4,000*		
-	**EXPENSES**		**30,000**	
=	**NET PROFIT**		**30,000**	

Although Trading and Profit and Loss Accounts do provide helpful information, it should be remembered that because they are totally based on money they may have ignored some of the following important factors that can affect decisions or alternatively be used to measure business success.

- *POSITIVE HIGH STAFF MOTIVATION or NEGATIVE LOW STAFF MOTIVATION*
- *POSITIVE LOW STAFF TURNOVER or NEGATIVE HIGH STAFF TURNOVER*
- *STAFF SKILL LEVELS FROM TRAINING*
- *PRODUCT RESEARCH AND DEVELOPMENT*
- *MARKETING EFFECTIVENESS (eg strong brand loyalty)*

BREAKEVEN ANALYSIS

BREAKEVEN ANALYSIS *is a process that uses the receipts and payments of a business to show calculate its' **BREAKEVEN POINT**.*

The **BREAKEVEN POINT** for a business is the amount of sales it needs to make in order to cover all of its costs. At this point, the business is neither making a **LOSS** (this is where there is more money going out than is coming in) or a **PROFIT** (this is where more money is coming in than is going out).

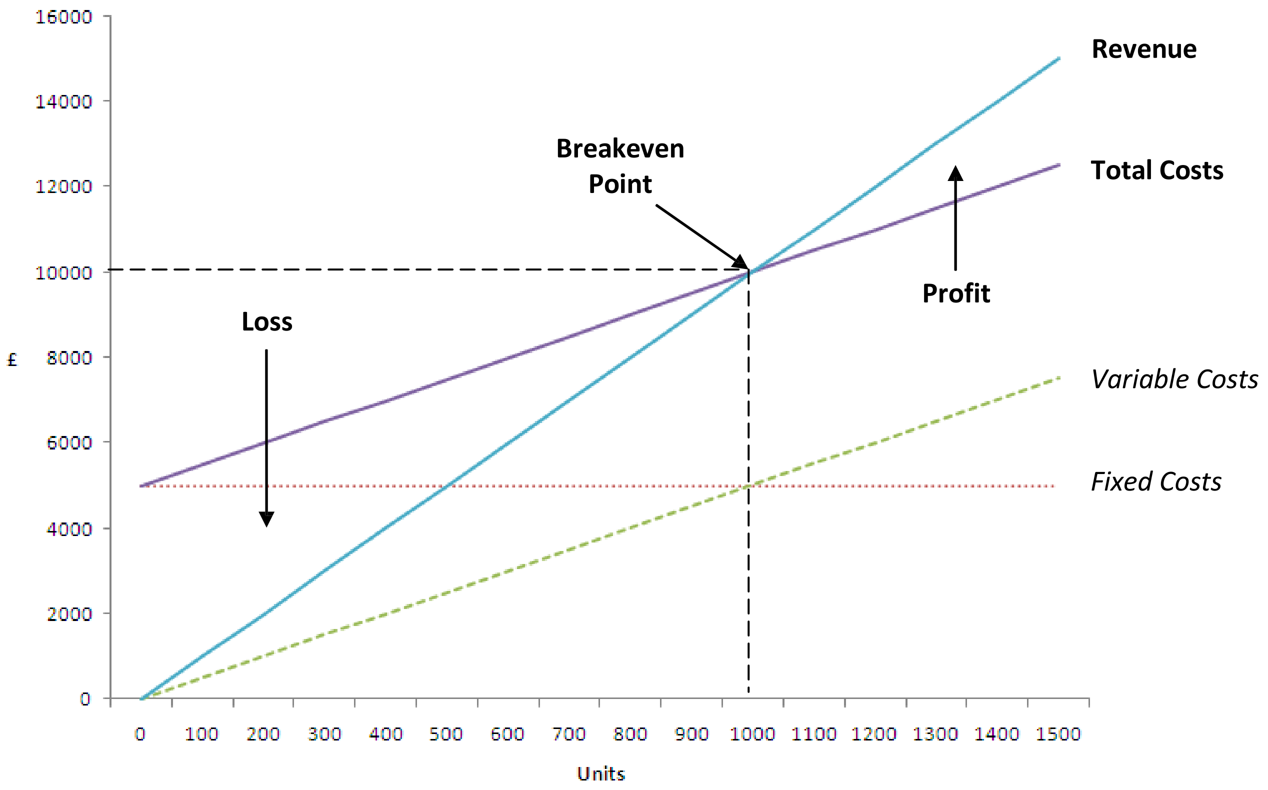
To calculate its' breakeven point, a business will have to gather the following data.

Data	Description
FIXED COSTS 	A fixed cost is one that **DOES NOT** usually change with the amount of products that a business makes. Examples of fixed costs include the following. • *RENT* • *RATES (this is a land tax to the Government based on the size of premises)*
VARIABLE COSTS 	A variable cost is one that **DOES** change with the amount of products that a business makes. Examples of variable costs include the following. • *WAGES (as more things are made more staff will be needed)* • *RAW MATERIALS (as more things are made more parts will be needed)*
TOTAL COSTS 	Total costs are the overall amount of fixed and variable costs that a business is paying for production.
REVENUE 	Revenue is the amount of money that a business is making from selling goods and services.

Businesses will be able to use this data to produce a **BREAKEVEN CHART** in order to calculate and visually show:

- *BREAKEVEN POINT (found where total costs **EQUAL** total revenue);*
- *LOSS (found where total costs are **MORE THAN** total revenue);*
- *PROFIT (found where total costs are **LESS THAN** total revenue).*

An example of a breakeven chart can be seen below.



Breakeven analysis is useful to a business for the following reasons.

- *BREAKEVEN ANALYSIS ALLOWS A BUSINESS TO SEE HOW MANY SALES IT WILL HAVE TO MAKE TO ELIMINATE LOSSES. THIS CAN HELP A BUSINESS SEE IF IT HAS ENOUGH FINANCE TO BE ABLE TO AFFORD TO WAIT THIS LONG OR WHETHER IT WILL HAVE TO SEEK MORE MONEY TO PREVENT FAILING BEFORE BREAKEVEN.*

- *BREAKEVEN ANALYSIS CAN SHOW EXTERNAL FINANCE PROVIDERS THAT A BUSINESS WILL BE PROFITABLE. THIS CAN HELP THE BUSINESS BECAUSE IT CAN PERSUADE THESE FINANCE PROVIDERS TO GIVE THE BUSINESS MONEY AS THEY CAN SEE THAT IT WILL BE ABLE TO MAKE MONEY AND PAY THEM BACK.*

- *THE BREAKEVEN POINT WILL HELP MARKETING AND OPERATIONS DECIDE HOW MUCH TO MAKE AND ADVERTISE. THIS WILL HELP THE BUSINESS MINIMISE WASTED PRODUCTION COSTS AND ENSURE THAT PROMOTION IS STRONG ENOUGH TO GET BEYOND THE BREAKEVEN POINT OF SALES.*

- *BY COMPARISON TO PROFIT AND LOSS ACCOUNTS, BREAKEVEN CHARTS MAY MAKE IT EASIER FOR PEOPLE TO UNDERSTAND THE PERFORMANCE OF THE BUSINESS AND SO HELP THEM BETTER MANAGE IT.*

SPREADSHEETS

> ***SPREADSHEETS** are computer programs that store and manage **NUMERICAL** information through the use of computerised calculations (known as **FORMULAS**) which should ensure that results are always **ACCURATE** and **AUTOMATICALLY UPDATE**.*

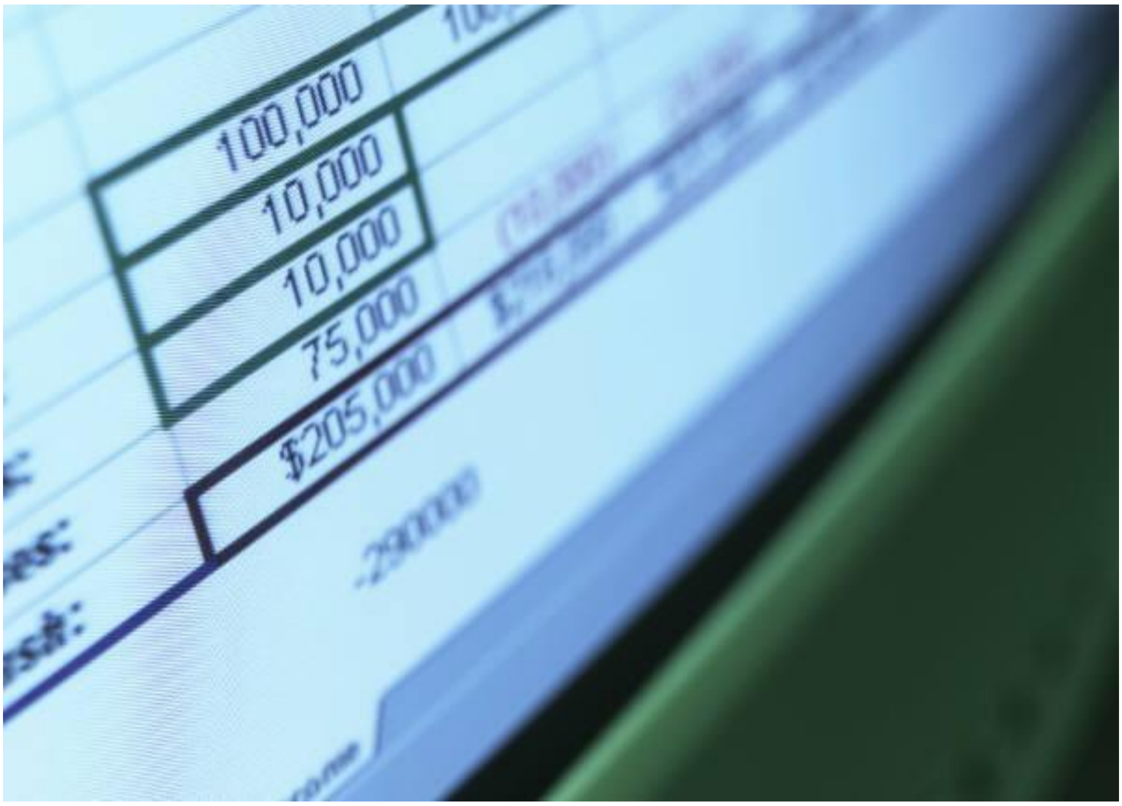
In many businesses nowadays, financial information (such Cash Budgets, Trading and Profit and Loss Accounts, or Breakeven Analysis) will be produced using a **SPREADSHEET** computer program.

Spreadsheets are being used more often for financial management tasks because of the following benefits they can bring compared to doing this work manually or though use of a calculator.

- *FORMULA CAN BE USED TO QUICKLY AND ACCURATELY CALCULATE INFORMATION*
- *FORMULA CAN BE USED TO UPDATE INFORMATION AUTOMATICALLY AND SO MINIMISE ERRORS*
- *EASY UPDATES ALLOW "WHAT IF" ANALYSIS TO INVESTIGATE RESULTS FROM DECISIONS*
- *CHARTS CAN BE CREATED FROM EXISTING INFO TO IMPROVE UNDERSTANDING*
- *ELECTRONIC SECURITY CAN BE EASILY PUT IN PLACE TO KEEP IMPORTANT FINANCIAL DATA SECURE*
- *AN EXTRA COPY (BACKUP) OF INFORMATION CAN EASILY BE KEPT TO DEAL WITH DATA ERRORS OR LOSS*

However, businesses which decide to use spreadsheets will have to accept the following costs:

- *COST OF PURCHASING THE NECESSARY IT HARDWARE AND SPREADSHEET SOFTWARE*
- *STAFF TRAINING TO ENSURE THAT THEY ARE SUITABLY SKILLED TO USE SPREADSHEETS*
- *POSSIBLE LOSS OF INFORMATION FROM EQUIPMENT PROBLEMS OR STAFF ERRORS*



WHICH FACTORS CAN AFFECT THE SUCCESS OF FINANCE ACTIVITIES?

The success of any operations activities undertaken by a business will be affected by the following factors. Therefore, a business should monitor each of these factors carefully and adjust their operations activities to deal with them in order to make sure that its' operations are as successful as possible.

1 INTERNAL FACTORS

Issue	Activity
FINANCE 	When a business has **LOTS** of finance (money) then it can make afford to invest **SURPLUSES** in profitable ways that will help the business survive. When a business does not have lots of money then there can be problems paying bills which could result in business failure.
HUMAN RESOURCES 	When a business has **LOTS** of well trained finance staff then it can make effective financial decisions (eg where to raise more finance) which will decrease the chances of the business running out of money and failing. When a business has ineffective staff then mistakes will be made and poor financial management can result in the business having to close.
CAPITAL 	When a business has **LOTS** of modern and efficient capital (such as spreadsheets) then it may be able to more efficiently monitor and manage the finance of the business. When a business cannot afford to make use of modern capital than work will have to be completed manually which could be slower and result in mistakes.

2 EXTERNAL FACTORS

Issue	Activity
POLITICAL ISSUES 	The Government may affect an organisation's finance through legislation and policies that affect the amount of payments to be covered and the amount of profit which is kept. For example, the increase in the tax rates will decrease the amount of profit left for owners.
ECONOMIC ISSUES 	Economic forces such as **INTEREST**, **UNEMPLOYMENT** and **INFLATION RATES** may affect an organisation's finance by increasing or decreasing the costs, etc. For example, inflation will make the cost of raw materials increase which may cause cashflow problems and business failure.
SOCIAL ISSUES 	The expectations and demands of the consumers in the market regularly vary and change. These factors must be constantly accounted for in the use of business finance. For example, the banking crisis in 2008 meant that society was increasingly interested in how banks were investing, and their charges and bonuses. This has meant that the way finances are managed in these businesses had to change before consumers took their money away from them.
TECHNOLOGY ISSUES 	Technology has affected finance in the following ways. • INCREASED AMOUNT OF ELECTRONIC PAYMENTS • INCREASED AMOUNT OF ELECTRONIC RECEIPTS • INCREASED USE OF SPREADSHEETS
ENVIRONMENT ISSUES 	Production processes which are environmentally friendly have become more necessary in recent years due to increasing public support for these practices and political changes. This can increase the costs and payments of a business and so could lead to cashflow problems.
COMPETITIVE ISSUES 	High levels of competition from other businesses for sales can affect the finance of a business. This is because businesses may have to lower prices to compete and so could find less cash coming in and the chance of running out of money and failing rising.