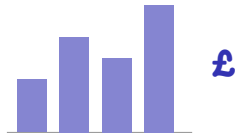


Finance & Accounting

A-Level Business ■ Topic 5

A-Level Business



What we will cover

- 1 Why finance & cash vs profit
- 2 Sources of finance
- 3 Cash-flow forecasts
- 4 Costs
- 5 Break-even & budgets
- 6 Recap





Spending and working capital

Capital spending buys assets that last (a van, a machine). **Revenue** spending is day-to-day (wages, stock). **Working capital** = current assets – current liabilities – the cash to keep trading.

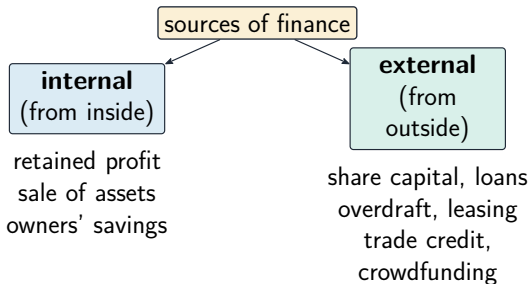
Cash is not the same as profit

Profit is revenue minus costs in a period. Cash is money in the bank. A profitable firm can still run out of cash if customers pay late or it buys a machine.

Cash flow keeps the business alive this month. Profit is why it is worth running.



Sources of finance



Internal (retained profit , asset sales) vs **external** (share capital , loan , overdraft , leasing).

Choose by amount, purpose, cost, structure & **collateral** .

Where the money comes from

Why it is needed

Business finance is the money a firm needs to start, run and grow – **premises** and equipment to begin with, projects to grow, and day-to-day bills always.

Internal sources

Internal sources : retained profit, and the **sale of assets** the firm no longer needs. No interest, no lost control.

External, short

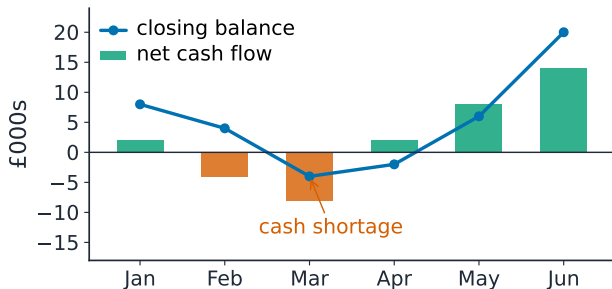
External sources : an overdraft, or **trade credit** – paying a supplier after 30 days.

External, long

A bank loan, share capital, or **venture capital** : money from investors into risky young firms, usually for a share of the business.

Match the term of the finance to the life of the asset: a 30-day credit for stock, a ten-year loan for a building.

Cash-flow forecasts



closing = opening + net · negative = cash shortage

Net cash flow = inflows – outflows; add to the **opening balance** for the closing balance.
Fix shortages: collect sooner, delay payments, arrange an overdraft, hold less stock.

Cash in, cash out – and what a forecast is for

Cash inflows

Cash inflows : money coming in, mostly from sales.

Cash outflows

Cash outflows : money going out – wages, rent, suppliers, tax.

The net position

Inflows minus outflows gives the net cash flow; add the opening balance for the closing balance.

What it shows

When the firm will run short – months before it happens, while an overdraft can still be arranged.

A profitable business can still fail: profit is a measure over a year, cash is a balance on a Tuesday.

Cash-flow trouble: causes and cures

causes

too many sales on credit, too much stock, too many assets bought at once, or overtrading

bring cash in

ask customers to pay faster, or discount for quick payment

push cash out later

negotiate longer credit from suppliers; lease rather than buy

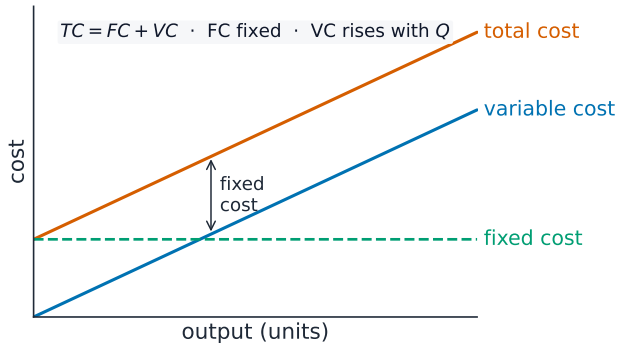
the balance

working capital management keeps enough cash to be safe without leaving money idle

A **cash-flow forecast** is worth making because it shows the shortage BEFORE it arrives.



Costs



total cost = fixed + variable.

- **fixed** (rent) vs **variable** (materials)
- **direct** vs **indirect** (overheads)

How costs are classified, and why

a cost

money the business spends to make its product

fixed and variable

fixed do not change with output; variable rise with each unit made

direct costs

traceable to one product – the materials in it, the labour on it

indirect costs

overheads not linked to one product – manager salaries, rent, insurance

average cost

total cost divided by output – the figure that falls with economies of scale

why classify at all

cost information helps managers **set prices, choose what to make, and control spending**

The same cost can be fixed *and* indirect, or variable *and* direct. The two classifications answer different questions and are not alternatives.

Break-even analysis

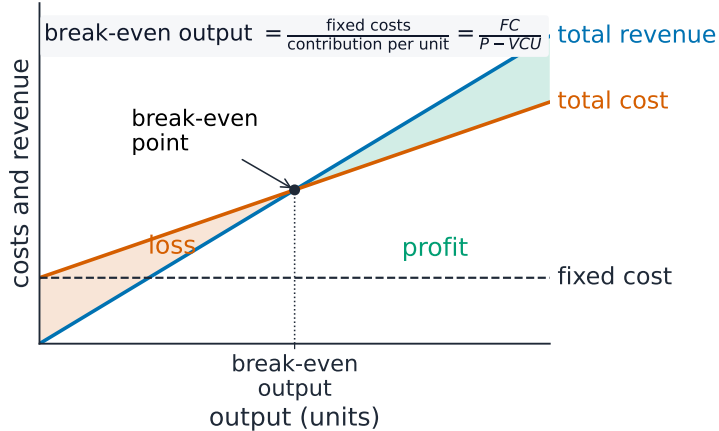
Contribution = price – variable cost.

$$\text{BEP} = \frac{\text{fixed costs}}{\text{contribution}}.$$

Price £20, VC £12, FC £40,000

contribution £8 $\Rightarrow$ BEP = 5000 units

Break-even analysis, in detail



The break-even point is where total revenue equals total cost – left of it is loss, right of it is profit

Costs, and what break-even cannot tell you

Variable costs

Variable costs rise and fall with output – raw materials, piece-rate wages.

Marginal cost

Marginal cost : the cost of making *one more* unit, which is what a pricing decision at the margin turns on.

Favourable variance

A **favourable variance** is better for profit – costs lower, or revenue higher, than the budget planned.

Limitations

Break-even's **limitations** : it assumes the selling price and the costs stay the same, and that everything made is sold.

It is a planning tool, not a forecast. Its answer is exactly as good as the two straight lines it draws.

Budgets and variances

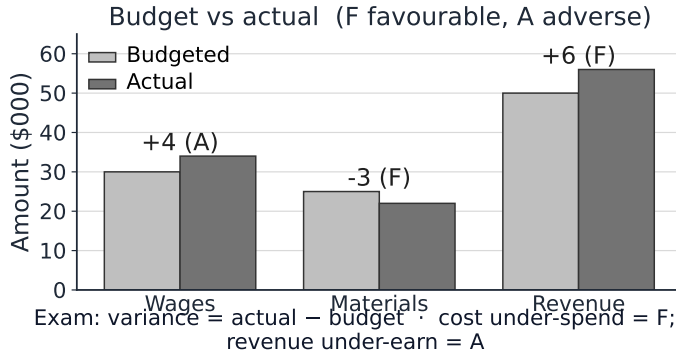
A **budget** is a financial plan. A **variance** = actual – budgeted.

- **favourable** – better for profit
- **adverse** – worse for profit

Wages

budget £30k, actual £34k
variance = £4k **adverse**

$$\text{Variance} = \text{actual} - \text{budget}$$



Variance = actual – budget: cost overspend is adverse; revenue over-earn is favourable

Cash is not the same as profit, continued

a firm can be profitable but still run out of cash

profit (on paper)
revenue — costs
= positive

cash (in the bank)
low — customers
haven't paid yet

Profit and cash are different: a firm can look profitable on paper yet have no cash to pay its bills – which is why many fail

Capital and revenue expenditure

capital expenditure

fixed assets that last
(machines, vehicles,
buildings)

revenue expenditure

day-to-day running
(wages, rent,
materials)

Capital spending buys fixed assets; revenue spending covers running costs

Two kinds of spending, and the working-capital test

capital expenditure

buying **long-lived assets** – machinery, vehicles, buildings.
Appears on the **balance sheet**

revenue expenditure

day-to-day running costs – wages, rent, materials.
Charged against this year's profit

working capital

current assets minus current liabilities

current assets

things that become cash within a year – cash, inventory,
money owed by customers

current liabilities

debts due within a year – suppliers, overdraft, tax due

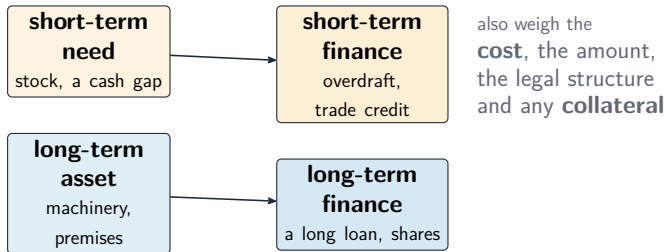
why it matters

a profitable firm with no working capital **still cannot pay its bills**

Cash is not profit. A firm fails when it runs out of **cash**, whatever the profit statement says.

Choosing a source of finance

match the finance to the purpose



don't pay for a long-lived asset with short-term borrowing

Match the finance to the purpose: short-term needs use short-term finance, long-term assets use long-term finance

What decides which source to use

the purpose

a long-lived asset needs long-term finance; a cash-flow gap needs an overdraft

the amount

a small sum from retained profit, a large one from shares or a bank

the cost

interest and fees differ sharply between sources

existing debt

how much the firm already owes – its **gearing**

collateral

an asset the lender can take if the loan is not repaid – without one, borrowing is dear or impossible

control

issuing shares raises money and **dilutes ownership**

There is no single best source. Every answer must name the firm's **situation** – purpose, size, gearing, ownership – before it names a source.

Sources of finance, continued



A stock exchange: public limited companies raise finance by selling shares

More sources of finance

hire purchase

external – buying an asset by paying in instalments, owning it at the end

leasing

external – renting the asset; never owned, but no large payment up front

crowdfunding

external – small amounts raised from many people online

microfinance

external – small loans for people with little access to banks

debentures

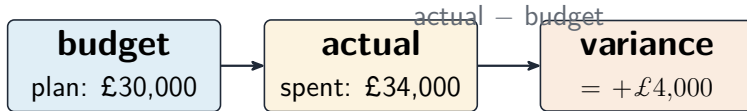
external – long-term loans that pay fixed interest, repaid at a set date

retained profit

internal – the cheapest source there is, and the one with no strings

Sort every source into **internal or external** and **short or long term** first. Those two axes answer most of the question before you consider cost.

Budgets and variances, continued



favourable: helps profit

adverse: hurts profit

(spend less, or earn more than planned) (spend more - as in this wages example)

a **budget** is a financial plan; the **variance** shows how far the actual result missed it

A variance is actual minus budget; favourable helps profit, adverse hurts it

Two ways to build a budget

incremental budget

last year's figures changed by a small amount – quick, and it **carries forward** old waste

zero-based budget

every cost must be **justified from zero** each year – thorough, and slow

a variance

actual minus budget

favourable

revenue above budget, or costs below it

adverse

revenue below budget, or costs above it

why analyse them

a variance shows managers **where the plan went wrong**, so they can act

An adverse variance is not automatically bad management: a cost overrun caused by *higher than budgeted sales* is good news. Say what caused it.

Working capital



Cash is working capital: firms need enough liquid assets to pay day-to-day bills

Exam tips

- Show that **cash is not profit** – a profitable firm can still fail from a cash-flow shortage.
- For **break-even**: $\text{contribution per unit} = \text{price} - \text{variable cost}$; $\text{break-even} = \text{fixed costs} \div \text{contribution}$; $\text{margin of safety} = \text{actual} - \text{break-even output}$.
- Match a **source of finance** to the need (short-term for cash flow, long-term or equity for assets) and to the type of business.
- Calculate a **variance** and label it **favourable or adverse** (actual against budget).



Topic 5 – key takeaways

1

Cash vs profit

a profitable firm can still run out of cash

2

Sources

internal vs external; short vs long

3

Break-even

$\text{BEP} = \text{fixed costs} / \text{contribution}$

4

Budgets

$\text{variance} = \text{actual} - \text{budgeted}$

Check yourself

- 1 Can a profitable firm run out of cash?
- 2 Retained profit: internal or external finance?
- 3 Contribution if price £15, variable cost £9?
- 4 Higher-than-planned costs: favourable or adverse?



Answers 1. yes 2. internal 3. £6 4. adverse