Effective financial management

How to improve cash flow

What is cash flow? The movement of money in and out of the business over a period of time

What are cash inflows? Cash inflows are *receipts*: ie money coming into the business

What are cash outflows? Cash outflows are *payments* ie money leaving the business

What is net cash flow? Net cash flow is the difference between cash inflows eg from sales and cash outflows eg from paying wages. Net cash = business receipts minus business payments

What is wrong with a cash surplus? Surplus cash can earn interest or profits if invested

What is wrong with a cash shortage? Cash shortages means firms must borrow to pay bills

What is financial management? Financial management involves planning ahead and anticipating future cash and finance needs

What is a cash flow forecast? A cash flow forecast predicts the future flow of cash in and out of the business over a given period of time eg three months.

How can firms improve cash flow? Put simply, by increasing receipts and reducing payments

How can firms increase cash receipts? Managers can draw more cash into the business by

- *increasing sales revenue* eg by selling more items at current prices by advertising
- *getting customers to pay bills quicker* eg by tightening trade credit terms
- *selling assets* such as little used equipment or property
- *destocking* ie running down inventories of components and finished items
- *arranging finance* eg an overdraft, new loan or extra share capital from owners

Explain trade credit. Most firms offer trade credit - customers buy now and pay later. Reducing the time customers are allowed to take to pay from 28 days to 14 days improves cash flow

Explain destocking. Destocking occurs when firms reduce their inventories eg by switching to just-in-time stock control, or holding the sale to sell off stocks of finished products

How can extra finance improve cash flow? Arranging a loan improves current cash flow. However future interest payments on the loan increases cash outflows

How can firms reduce cash payments? Firms can stem cash outflows from the business by

- delaying or cancelling orders for supplies
- arranging better credit terms with suppliers or
- delaying payment of bills to creditors – or even workers
- leasing rather than buying new equipment like a company car

How to improve profit

What is profit? Profit is the amount left over from revenue after paying all costs

What is a profit margin? A profit margin is the amount of profit made on each £1 of sales. Eg a profit margin of 20% means 20p for every pound of sales.

Explain losses. A business makes a loss when total revenue is not enough to cover costs

State the formula for calculating profit or loss. Profit or loss = total revenue – total costs

Give an example of profit. The window cleaner estimates he has 40 houses to visit next week. Given an average selling price of £8 total revenue is forecasted to be £8 x 40 = £320. Total costs are £250 giving an expected profit of £320 total revenue less £250 total costs = £70 profit.

Give an example of loss. One day that week the van breaks down and 10 houses are not cleaned. Revenue is £8 x 30 = £240. If costs remain the same at £250, a £10 loss is made

How can firms raise profit? Put simply, profits grow by cutting costs or raising revenues

How can costs be cut? The entrepreneur can attempt to

- Use cheaper components or raw materials - while maintaining quality
- Cut *wages* or even sack some staff – while maintaining productivity
- reduce marketing – while maintaining sales levels
- cutting back on *investment* in new equipment, training and research and development - while maintaining productivity, customer service and new product development

How can revenue be raised? The entrepreneur can try to

- improve marketing to increase the quantity of sales at current prices or to increase price while maintaining the quantity of sales
- launch new and improved products which better meet customer needs - while maintaining profit margins

Does cutting price always increase revenue? Revenue has two components price and quantity. Cutting price has two opposites' effects on revenue 1)more items are being sold – a revenue booster 2) each item is being sold a lower price - a revenue cutter

Cutting price only increases revenue if demand is price elastic. This is because the effect of the percentage increase in quantity outweighs the percentage decrease in price

When does raising price increase revenue? A price increase raises revenue only if demand is price inelastic: the percentage increase in price effect outweighs the percentage fall in quantity

Break even analysis

How is profit calculated? Profit is found by deducting total costs from total revenue

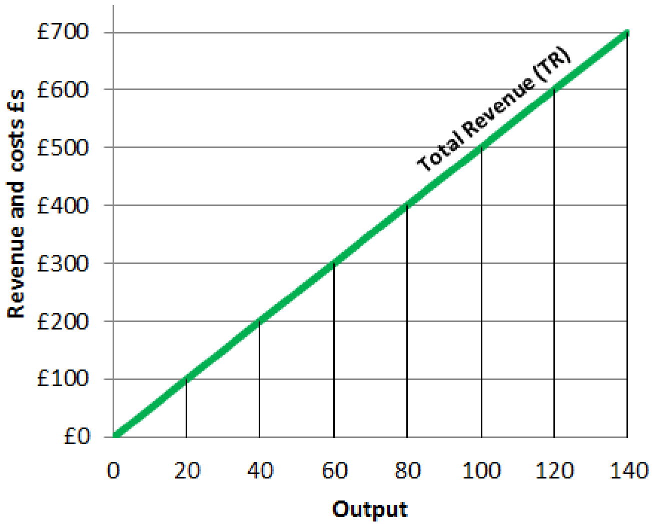
Explain break even. Break even is the output level when total revenue equals total costs. At the break even level of output the business is making neither a profit nor loss. Sales cover costs.

What happens if the firm sells more than its break even level of output? Beyond the break even level of output, revenue exceeds cost and the firm is making a profit.

What happens if a firm fails to sell its break even level of output? Revenue is less than cost, and the business is making a loss.

Define total revenue. The entire income earned by a business from its sales over a period.

Interpret the Total Revenue graph.



The horizontal axis shows the number or items sold by the firm ie sales, output or quantity

The vertical axis shows the total revenue earned from selling each level of output

The graph tells us that the firm earns £100 from selling 20 units – this is its total revenue

Selling price is £5 per item

The total revenue line slopes upwards because as more is sold, total revenue rises

Define total costs. The entire amount spent by a firm making its products over a period.

What are costs? Cost is the amount spent by firms making products.

State the main types of cost. There are two main types of cost: fixed cost and variable cost

Explain fixed costs. Fixed costs are costs that do not change as output changes. Fixed costs such as rent and interest stay the same even if more is produced.

Make a list of common fixed costs. Rent for business premises, interest payments, loan repayments, administration staff wages, internet and phone bills, insurance payments, and advertising costs. These costs remain the same even if output rises in a period.

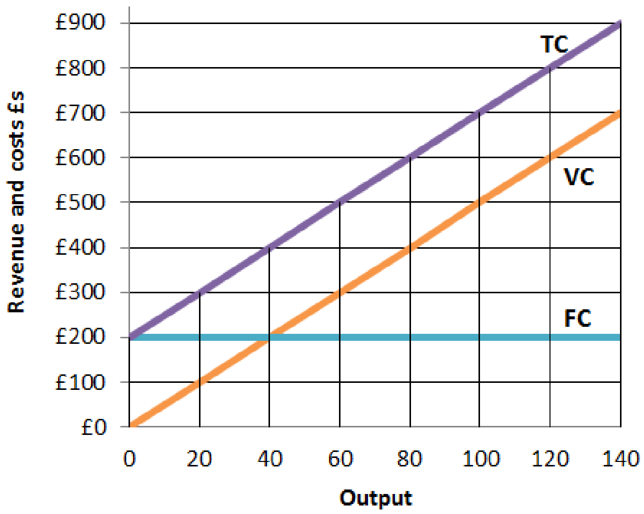
Explain variable costs. Variable costs change with the amount produced. For example, the cost of raw materials used in production rises as more output is made.

Make a list of common variable costs. Examples of variable costs include the wages of production workers; raw materials; fuel, gas, electricity and petrol used in production; packaging of the finished product.

How can entrepreneurs determine which costs are fixed or variable? A business person asked themselves: does this cost go up if just one more item is made? Extra production increases variable costs but leaves fixed costs unchanged

What are total costs? Total costs are the amount of money spent by a firm on producing a given level of output. Total costs are made up of fixed costs (FC) and variable costs (VC).

Interpret the Fixed, Variable and Total Cost Graph



The *fixed cost* line is horizontal because no matter how many items are made, fixed costs like rent stay the same. Fixed costs are £200.

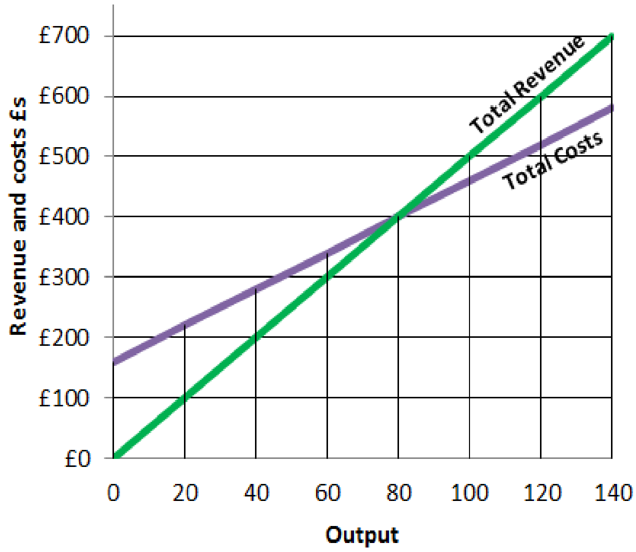
The *variable cost* line slopes upwards because as more items are made variable costs such as packaging rise

Adding the variable cost line to the fixed cost line gives the *total cost* line.

The vertical distance between the TC and VC lines equals the amount of the firm's fixed costs

What is a margin of safety? When the quantity sold is above the break even point. The firm is making a profit.

Interpret the break even chart. The break even chart shows the total revenue and total cost lines, together. The break even level of output (BEQ) is where the total cost and total revenue lines cross ie 80 units



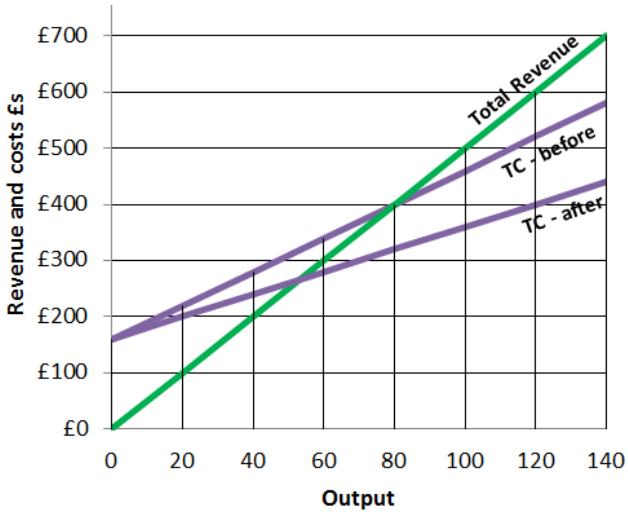
- If the firm sells less than 80 units it is making a loss.
- If the firm can sell more than 80 units it is making a profit

Selling more than 80 units give the firm a margin of safety

How do firms make use of break even analysis? Break even analysis helps a firm forecast the level of sales needed to break even. A firm can see the impact of price and costs changes on BEQ

What happens to cost lines if costs changes? An increase in costs moves a cost line upwards. Any fall in costs, say from a rise in productivity, moves a cost curves downwards

Use a Break Even graph to show the effect of a fall in costs



The Total Cost line moves downwards because variable costs have fallen. The break even level of output falls from 80 units to 50.

Extension point: Note fixed costs have stayed the same at £160. This means the total cost line pivots on the vertical axis around £160.

A change in just fixed costs from, say, cutting overheads causes a parallel shift in the total cost curve, rather than a pivot

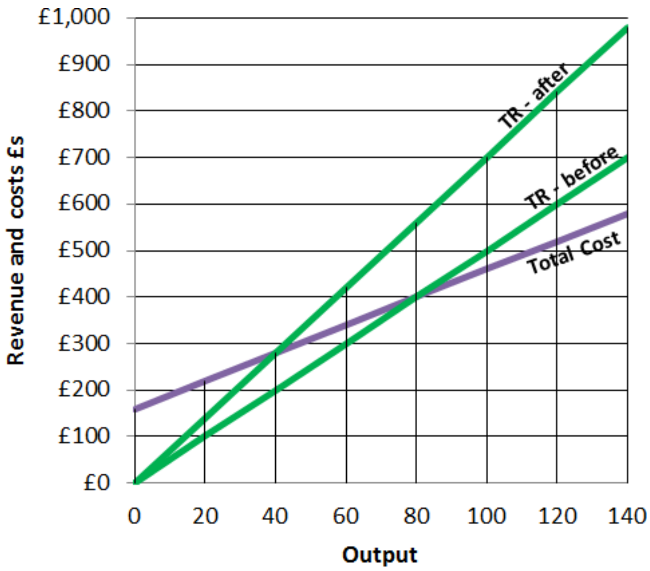
What happens to the total revenue line if price changes? An increase in price causes the total revenue line to pivot around zero and become steeper. A price cut has the opposite effect. The TR line pivots around zero and becomes shallower

Use a break even graph to show the effect of a price rise.

The TR before line shows total revenue for each level of output when price is £5. The break even level of output (BEQ) is 80.

If price rises by £2 to £7, the TR line pivots around zero and moves upwards to TR – after. The BEQ falls to 40 items

Extension point: can the business be confident that customers will still buy their product if price rises by £2. What happens if competitors keep their prices low or if buyers feel the product is now too expensive?



Contribution

What is contribution? Contribution is the extra revenue generated over variable costs when selling a product

How is contribution calculated? Contribution is found by deducting unit variable cost from the selling price

State the formula for calculating contribution. Contribution per unit = selling price– unit variable costs

Give an example of calculating contribution. The price of a pie is £2.50. The average or unit variable cost of making one pie is £1.50. This means each pie sold contributes £1.

What happens to contribution? The contribution made by each item is first used to pay off fixed costs and then towards making a profit

How is contribution used to estimate the break even level of output (BEQ)? Firms use the formula BEQ = fixed costs / contribution per unit

Give an example of contribution analysis. If fixed costs are £10,000 and each unit contributes £5 then the break even output level = £10,000/£5= 2,000.

Financing growth

How can a business grow? To increase its size of operation a business needs to invest in extra staff machinery and premises, R&D or takeover a rival. Each option needs finance.

What is finance? Finance is the amount of money at the disposal of a business

What is a source of finance? The source of finance is the origin of money a business has

What type of debt do firms typically use to finance growth? Some sources of finances are short term, that is, they need to be repaid initial period of time eg an overdraft. Buying new equipment and building is a long-term decision requiring a long-term source of finance

List sources of finance not suited for investing in growth. Overdrafts, trade credit and factoring are best used to manage short-term cash flow problems- not finance long-term growth

How can businesses finance growth? There are two main sources of funds for growth:

- *Internal*: within the firm itself eg from *asset sales* or retained profit
- *External*: outside the firm eg a *debt* (borrowing) or *share capital*

Explain the term assets. Assets are items of value owned by a firm eg equipment and stock

How can firms raise funds from assets? Firms can raise funds for growth by selling unwanted or under-used assets. Eg selling a non-essential building releases funds for growth

What happens to profits? Profits can be

- *Distributed* ie paid out to owners as a reward for risk taking investment or
- *Retained*: kept back to finance extra spending on new equipment or premises

How can retained profits finance growth? Expanding firms need to find the money to buy new buildings and equipment. One method is to make use of past profits. No interest is charged.

How can debt finance growth? Debts arise when firms borrow money eg by taking out a loan

Describe types of debt best suited for financing growth. Businesses can borrow money by

- Taking out a *loan* - usually from a bank. Funds are borrowed for a fixed period of time and repaid regularly with interest. Eg £60,000 is repaid monthly over five years with 10% pa interest added
- Selling *bonds* (*debentures*) to banks and private investors. A bond is an IOU promising to pay whoever owns the debenture a regular fixed annual interest payment eg 10%.

List the drawbacks of using loans. Loans are repaid with interest which increases overheads and reduces cash flow for the period of the loan. Collateral may be required.

What is share capital? Some business called companies can raise finance by issuing shares. The value of all the shares sold to investors by company is its share capital.

What is a company? A company is a business with its own legal identity and is owned by shareholders. Sole traders and partnerships are not companies

What is a shareholder? Someone who has bought shares and so owns part of a company

What are shares? A share is a certificate that represents a part ownership of the company. Usually each share gives the owner the right to one *vote* at any shareholder meeting and *part of any profits* distributed to shareholders called a *dividend* (profit payment)

How can a business raise funds using shares? Companies can raise finance for growth by selling new shares to private investors. This is called a *rights issue*.

Why are shares a popular source of company finance? The money invested by shareholders does not need to be repaid. There are no interest payments to make.

List the drawback of issuing shares. Increasing the number of shareholders can mean existing owners lose control and have to share profits

What is the stock market? The stock market is the place where shares are bought and sold

List the two types of company found in the UK. There are two main types of company: private limited company (Ltds) and public limited company often called Plcs

What is the main difference between private and public limited companies? New shares in private limited companies cannot be advertised for sale and are not listed on the stock exchange. Members of the general public can be invited to buy new shares in public limited companies which can be bought and sold on the stock exchange

What is a stock market flotation? A stock market flotation is when a private limited company converts to being a public limited company and offers shares for sale to the general public

Why do private limited companies decide to float? Converting to a plc means a business can raise very large sums of money (£m) by offering new shares for sale to the general public

How do firms decide on the best source of finance? In raising extra funds owners consider:

- *Cost*: how much will borrowers charge for use of their funds eg the interest rate on loans
- *Risk*: eg can the business afford to pay interest charges if it makes unexpected losses
- *Availability:* eg only companies can issue new shares; banks may restrict credit

	Loan	**New shares**
Cost	Banks's Arrangement fee Annual interest charges. Loans must eventually be repaid	Floatation/rights issue complicated and costly But share capital is like an interest free loan that never needs to be repaid
Risk	Loss making firms must still pay interest charges	Loss making firms stop paying dividends
Availability	Banks may require collateral or refuse to lend	Only companies can issue shares

How can government help finance growth? State can offer interest-free loans, grants that do not need to be repaid and tax breaks to businesses locating in deprived areas or investing in new technologies.