# Unit 2 Finance for Business

## Learning Aim A understand the costs involved in business and how businesses make a profit

| Key Term | Definition | Example and / or Formula |
|---|---|---|
| start-up costs | the costs incurred when setting up a business | Sign, Market Research, Furniture, Equipment |
| operating (running) costs | – the costs incurred in the day-to-day running of a business. These can also be known as **overheads** | Stock, Materials |
| Fixed Costs | Costs which don't change with output (how many items you make or sell) | Rent, Rates, Insurance, Salary |
| variable costs | Costs which do change with output (how many items you make or sell | Raw Materials, Stock, Wages, Electric used to make product |
| Direct Costs | Costs that are directly linked to making the product | Raw Materials and staff wages |
| indirect costs | Costs that aren't directly linked to making the product | Rent, Phone, Bills and Salaries |
| total costs | All of your costs added together | Fixed Costs + Variable Costs |
| Profit | revenue is more than expenditure | Revenue - Expenditure |
| loss | expenditure is more than revenue | If you have -£500 at the end of the year |
| Revenue | How much money is coming into the business | Total sold x Selling Price<br>Selling goods, hiring out equipment/premises, selling shares |
| Expenditure | What businesses spend their money on | Rent, rates, stock, gas |

### Key Facts

Businesses generate revenue (make their money) by selling products or services. They can also generate revenue from renting out part of their premises or equipment too!

Businesses have to spend money (expenditure) in order to succeed. They need to reinvest in stock that is selling well and try to improve the business through expansion of products sold, services offered etc. They might need to spend money on promotion and marketing to encourage people to buy their products

Expenditure is anything a business pays out and overheads are the everyday running costs of a business

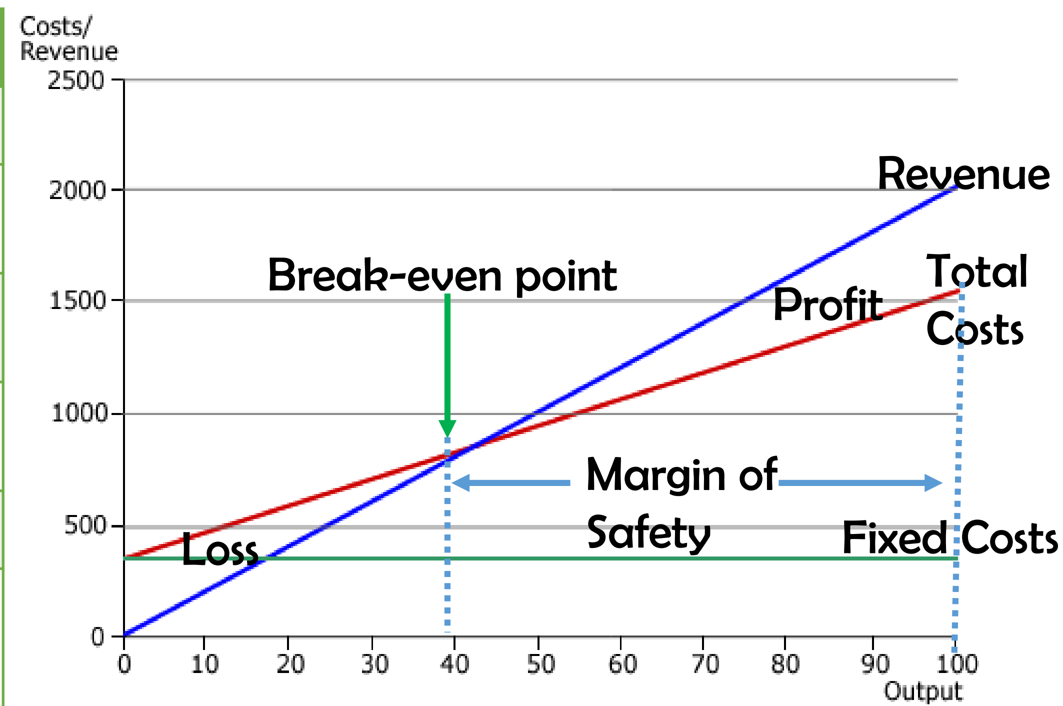
Businesses must know how much money is coming in (revenue) and going out (expenditure), before they can work out whether the business has made a profit or made a loss

You must remember the formulas - as these are not given in the exam!!

Unit 2 Finance for Business

## Learning Aim B Understand How Businesses Plan for Success

| Key Term | Definition | Example and / or Formula |
|---|---|---|
| Break Even | Works out how many items a business must sell in order to make a profit | |
| Margin of Safety | The difference between the sales made and the break even point | Total Sales – Break even point |
| Fixed Costs | Costs which don't change with output (how many items you make or sell) | Rent, Rates, Insurance, Salary |
| Variable Costs | Costs which do change with output (how many items you make or sell | Raw Materials, Stock, Wages, Electric used to make product |
| Total Costs | All of your costs added together | Fixed Costs + Variable Costs |
| Break-Even Point | When the amount of money spent on making/buying in the product is the same as the money made from selling the product | Fixed Costs / (Selling price per unit – Variable Costs per unit) |
| Profit | Sales made after the break-even point are a Profit for the company | |
| Loss | Sales made before the break-even point are a Loss for the company | |
| Changes to Variable or Fixed Costs | If variable costs decrease, each unit costs less to make. This means they have to sell less to break even. If revenue stays the same they will make a bigger profit | If costs increase, each unit costs more to make. This means they have to sell more to break even. If revenue stays the same |
| Changes to Sale Price | If the selling price increases the break even point will be lower so they need to sell less. This could affect sales as people won't pay as much so revenue would be less | If they lower the selling price the break even point will be higher so will need to sell more. The lower price might attract more customers and boost their total revenue |




### Key Facts

Break Even helps a business by showing how many units it needs to sell to cover its costs. It shows when it will start to make a profit and the lowest amount they can sell so they don't make a loss. It can show the margin of safety and if costs or selling price change how that will affect the profit or loss

You must remember the formulas as these are not given in the exam!!

## Learning Aim B Understand How Businesses Plan for Success

| Key Term | Definition | Example and / or Formula |
|---|---|---|
| Budget | Shows how much money a business is going to spend & receive over a certain time period | Budgetary control is when you compare the budget figures with the actual figures |
| Cash Flow Forecast | A cash flow forecast shows what money will come in and go out of the business each month. It shows if they have enough money to pay its debts (bills). | using a cash flow forecast helps to plan for success e.g. to produce new goods / services, invest in new resources, expand or reduce business activities |
| Cash Inflow | The sources of money coming into the business | Loan, savings, sales revenue |
| Cash Outflow | The sources and destination of money leaving the business | Rent, electric, gas, interest, stock, rates etc |
| Profit | Sales made after the break-even point are a Profit for the company | |
| Loss | Sales made before the break-even point are a Loss for the company | |
| Reinvestment | If there is a cash surplus you can move your money elsewhere | Extra advertising, Open a new premises, develop a new product, staff training etc. |
| Cash Deficit | When a business does not have enough money to pay the outflows. Negative number | Solutions – Overdraft, Loan, credit (spreading or delaying the payments) |

| | December | January | February |
|---|---|---|---|
| **Cash Inflows:** | | | |
| Peter & Sue's Savings | 5, | | |
| Bank Loan | 7, | | |
| Sales Revenue | 3, | 000 | 8,800 |
| **Total Cash Inflow** | **16,300** | **6,000** | **8,800** |
| **Cash Outflows:** | | | |
| Pu ocks of foo | 8,000 | 4,250 | 3,900 |
| Wa | 4,000 | 3,500 | 3,700 |
| Int k loan | | | 250 |
| Rent (for 3 months) | | | |
| Electricity & gas | | | |
| **Total Cash Outflow** | **16,750** | **8,220** | |
| **Net Cash Flow** | **(450)** | **(2,220)** | |
| **Opening balance** | **1,000** | **550** | |
| **Closing balance** | **550** | **(1,650)** | **(930)** |

Total cash inflow is all inflows added together

Total cash outflow is all outflows added together

Net cash flow = Total Cash Inflow – Total Cash Outflow

A number in brackets means it is a minus number i.e. -£ 1,670

Opening balance = previous months closing balance

Closing balance = Net cash flow + Opening Balance

Unit 2 Finance for Business

## Learning Aim B Understand How Businesses Plan for Success

| Benefits of Cashflow | Risks of Cashflow |
|---|---|
| The timing of when the inflows (revenue) and outflows (expenditure) is known | Late inflows may not be identified |
| Possible problems are spotted quickly | There may not be enough cash to pay bills/wages |
| Surplus (spare) cash can be invested | Suppliers may refuse to trade with the business if they have a reputation for non-payment |
| Expensive items can be bought at the best time or you can look to buy on credit or lease (rent) | An overdraft or loan might need to be arranged which can be costly |
| The business can plan to expand or reduce activities | The business may run out of money and close |

| Short Term Problems & Actions | Long Term Problems |
|---|---|
| Delayed payments from customers – Chase up customers | Too little revenue – try and increase sales/widen product range |
| Lots of bills arriving at the same time – renegotiate payment dates | Expenditure is too high – reduce costs/change suppliers |
| Obtain a temporary loan to help | |

### Impact of timings on Cash Flow

The dates when money is received can be really important when managing cash flow. As budgets will be managed around these dates.

If you pay by cash the business has money immediately. If it is on credit the business has to wait the agreed time (DFS offer 4yrs free credit other businesses might wait 30 days)

If payments come in later than expected this can affect cash flow.

Seasonal businesses (fairgrounds, ice cream van etc) will have more money coming in for part of the year (surplus) and then be in a deficit (not enough money) the rest of it.

To manage inflows a business can;
Send out invoices promptly and chase them up if not paid
Avoid giving credit to unknown customers
Offer discounts if you pay early

To manage outflows a business can;
Delay some payments
Reduce stock levels
Delay a big project
Make cutbacks to reduce costs

# Unit 2 Finance for Business

## Learning Aim C Understand how businesses measure success and identify areas for improvement

| Cost of Sales | Gross Profit |
|---|---|
| Cost of Sales are items used to make the product. Eg Jamie makes jeans so his raw materials are Denim, fastenings and zips. If he makes 1500 pairs of jeans and the costs are £8 per pair. Her total costs are £12000 (1500 x 8)<br><br>Formula:<br>Gross Profit = Revenue – Cost of Sales<br>The cost of sales is taken away from the revenue to find Gross Profit | Gross Profit is how much money is left from selling an item after you have deducted the cost of making it.<br><br>Formula<br>Gross Profit = Revenue – Cost of Sales<br><br>If Jamie sold his jeans at £25 his revenue is<br>1500 x 25 = £37500 - £12000 cost of sales<br>Gross Profit = £25500 |
| **Impact of Positive Gross Profit** | **Impact of Negative Gross Profit** |
| There is money to pay for the expenses | There is no money to pay expenses/wages without getting an overdraft or loan which will increase costs |
| There might be money left over for new equipment/expansion | The Cost of Sales is too high – could this be reduced by changing supplier |
| The cost of Sales isn't too high | Sales revenue is too low – more goods must be sold |
| Enough goods are being sold to produce a profit | |

| Net Profit | Financial Statements |
|---|---|
| Net Profit is how much money is left after you have deducted all the costs of the business from your gross profit.<br><br>Formula<br>Net Profit = Gross Profit – Expenditure<br><br>If Jamie sold his jeans at £25 his revenue is<br>1500 x 25 = £37500 - £12000 cost of sales<br>Gross Profit = £25500 | Financial statements show whether or not a business is doing well. Their purpose is to record the financial activities of the business. Provide an overview of the financial position and whether the business is well managed and successful.<br><br>They are read by Shareholders, competitors, managers, employees, suppliers, the government and customers<br><br>There are 2 types – Income statement (profit and loss account) and statement of financial position (balance sheet) |
| **Impact of Positive Net Profit** | **Impact of Negative Net Profit** |
| Gross Profit is positive | Gross Profit is low or negative |
| There is money left over for new equipment/expansion | Expenditure is too high |
| Expenditure is less than gross profit | The Business is losing money |
| | |
| Assets – items owned by the business and worth money | Liabilities – debts or obligations the business has |

# Unit 2 Finance for Business

## Learning Aim C Understand how businesses measure success and identify areas for improvement

## Income Statement

The top part is the TRADING ACCOUNT. It shows the Gross Profit

Formula:

Gross Profit = Revenue – Cost of Sales

The cost of sales is taken away from the revenue to find Gross Profit

The next part lists and adds up the expenses

**Trading and Profit and Loss Account**
For the Year ending 31st December

| | £000 | £000 |
|---|---|---|
| TURNOVER | | 300 |
| COST OF SALES | | |
| Opening Stock | 40 | |
| PLUS Purchases | 120 | |
| | 160 | |
| LESS Closing stock | 30 | |
| | | 130 |
| GROSS PROFIT | | 170 |
| ADMINISTRATIVE EXPENSES | | |
| Wages | 50 | |
| Insurance | 2 | |
| Rent | 30 | |
| Rates | 11 | |
| Telephone | 4 | |
| Advertising | 11 | |
| Depreciation | 5 | |
| Computer Costs | 10 | |
| Light and Heat | 1 | |
| | | 124 |
| NET PROFIT | | 46 |

The final part calculates the NET PROFIT by taking away the total expenses from the gross profit

Formula

Net Profit = Gross Profit – Expenditure

Working Capital (Net Current Assets) is the money the business needs every day to trade and pay its bills. Current Assets need to be more than Current Liabilities. This means you have enough money to pay your bills and have money left over.

Working Capital = Current Assets – Current Liabilities

## ASSETS

Assets are items the business owns or are owed to the business.

Fixed Assets – Something of worth that lasts a long time. For example, Vehicle, Computer, machinery

Current Assets – Assets which can be easily converted into cash. For example, stock which can be sold to customers, Cash received from customers and Trade Receivables (DEBTORS) This is customers who owe the company money (like a buy now pay later)

## LIABILITIES

Liabilities are DEBTS OWED by the business. Examples of these are;

Current Liabilities – Debts that need to be paid soon. This can include Trade Payables (CREDITORS) people you owe money to such as suppliers of your stock, Overdrafts or Short term bank loans.

Long-term Liabilities – Funds borrowed over a long time such as a mortgage.

## Statement of Financial Position

The purpose of a balance sheet is to show the financial position of the business at a certain time. It shows how the business spends it money (assets & liabilities) and how it is funded (capital)

The Shareholders funds section shows Capital – money from internal (shareholders) & external sources (bank loans).
Retained profit – previous profits the owner has kept in the business.

**GoFaster Sports**

Balance Sheet as at 31 July

| | £000 | £000 | £000 |
|---|---|---|---|
| **Fixed Assets** | | | |
| Equipment & Fittings | | | 25 |
| Vehicles | | | 15 |
| | | | 40 |
| **Current Assets** | | | |
| Closing Stock | | 15 | |
| Debtors | | 5 | |
| Cash at Bank | | 10 | |
| | | 30 | |
| **Current Liabilities** | | | |
| Creditors | 5 | | |
| **Net Current Assets** | | | 25 |
| **Net Assets** | | | 65 |
| **Financed by:** | | | |
| **Capital** | | | 45 |
| **Net Profit** | | | 20 |
| | | | 65 |

Unit 2 Finance for Business **Learning Aim C** Understand how businesses measure success and identify areas for improvement

| Analysing an Income Statement (profit & loss account) | Analysing a statement of financial position (balance sheet) |
|---|---|
| Businesses need to increase profits if their income statement /profit & loss account shows they are low.<br><br>They can do this by increasing revenue (sales) or reducing costs.<br><br>To increase Gross Profit they can negotiate cheaper prices with suppliers, use different materials, sell more products or increase the selling price if possible.<br><br>To increase Net Profit you can reduce expenses like changing utility supplier, move premises, reduce staff or reduce pay rates | When analysing a Balance sheet look at each of the figures given.<br>Stock – too high? Sell it Too low? Buy some more<br>Trade Receivables (debtors) – If high then collect your payments from your debtors<br>Cash – if low then chase up debts to get the money in or sell off slow-moving stock<br>Trade payables – if too high suppliers might stop providing your products<br>Overdraft – this costs money in bank charges – get rid asap!<br>Working Capital – must be enough to pay the day to day bills! |
| **Negatives** | **Impact of Negative Gross Profit** |
| If you buy cheaper raw materials it may reduce the quality of the goods. | Lowering staff wages could lose staff |
| Increasing selling prices could mean fewer sales | More advertising can reduce |