Unit 1: Financial planning and analysis

1.1. Business planning

Business planning

In this unit you will be focusing on why business enterprises plan their finances.

- A business plan is an important part of setting up a business
- A business plan will be used both internally by the entrepreneur and externally by banks, external investors or those willing to provide grants
- The contents of a business plan include:
    - The executive summary - a synopsis of the entire plan looking at the most important points
    - The business and goods or services
    - The market e.g. size, share, competitors
    - The marketing strategy
    - The skills of the entrepreneur and other key employees
    - Operations
    - Financial forecasts

Main Types of Financial Objective

- REVENUE OBJECTIVES
- COST OBJECTIVES
- PROFIT OBJECTIVES
- CASH FLOW OBJECTIVES
- INVESTMENT OBJECTIVES
- CAPITAL STRUCTURE OBJECTIVES

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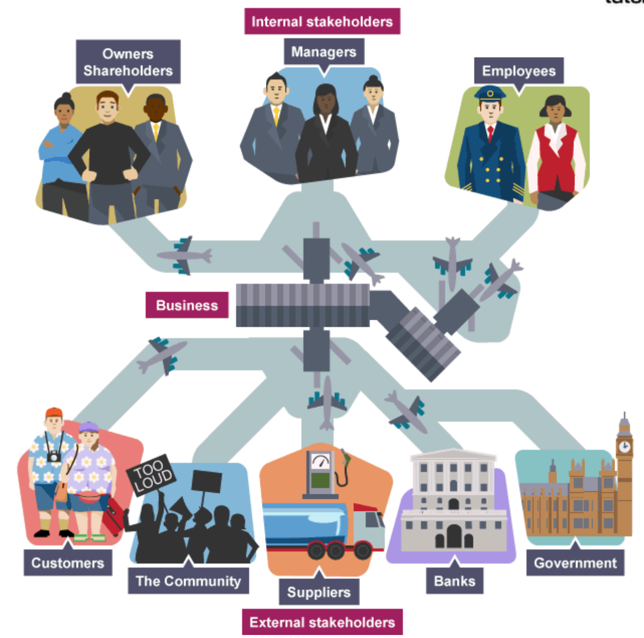

<u>Key Terms:</u>

Business Plans
Stakeholders
Running Costs
Profit

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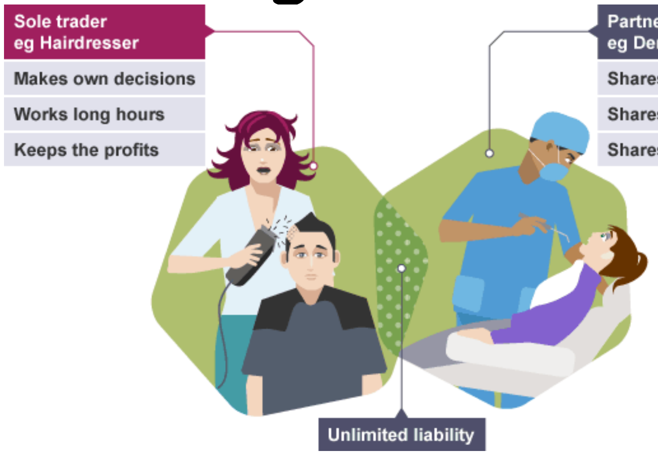
1.2. Legal structures of business



Limited company (1)

- Limited companies are **separate legal entities** to the founders. A legal entity can own things itself (assets), can sue and be sued
- Companies are owned by their shareholders and run by directors.
- The shareholders appoint the directors (who in most cases are one and the same people!) who run the company in the interests of the shareholders
- Shareholders own a share of the company, but they do not own the assets of the company and they are not liable for the debts of the company

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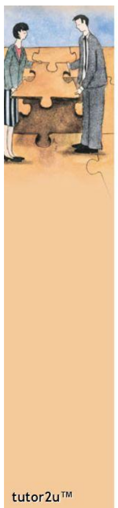
Community interest companies (CICs)

- Not all businesses will have an objective of profit
- Businesses may have an objective to do good for society and any surplus made is ploughed back into achieving that goal
- These may be social enterprises or charities
- In 2005 the UK Government introduced CICs to allow social enterprises to enjoy the advantages of operating as a company



Partnership

- Ownership of business shared between partners
- Most partnerships have between two and twenty members though there are examples like the major accountancy firms where there are hundreds of partners
- Rules of the partnership described in the **Deed of Partnership**. This contains:
  - Amount of **capital** each partner should provide
  - How **profits or losses should be shared** amongst the partners
  - How many **votes** each partner has (usually based on proportion of capital provided)
  - Rules on how to take on new partners
  - How the partnership is brought to an end, or what happens if a partner leaves/dies

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Key Terms:

Sole Trader

Business Partnership

Limited Company (Ltd)

Public Limited Company (PLC)

Type of business	Private limited company (ltd)	Public limited company (plc)	Franchises	Cooperative
	TOP BAKES	Salamander	Happy Burger	Group Co
Owned by shareholders	✓	✓		
Leasing brand name to franchisee			✓	
Owned by workers				✓
Run by board of directors	✓	✓		✓
Run by franchisor			✓	
Funded by retained profits	✓	✓		✓
Funded by shares	✓	✓		
Funded by royalties			✓	

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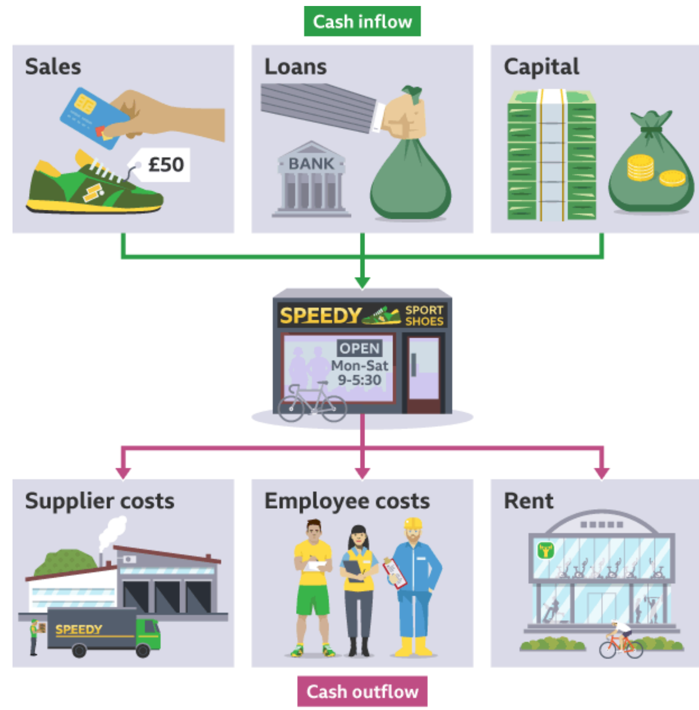
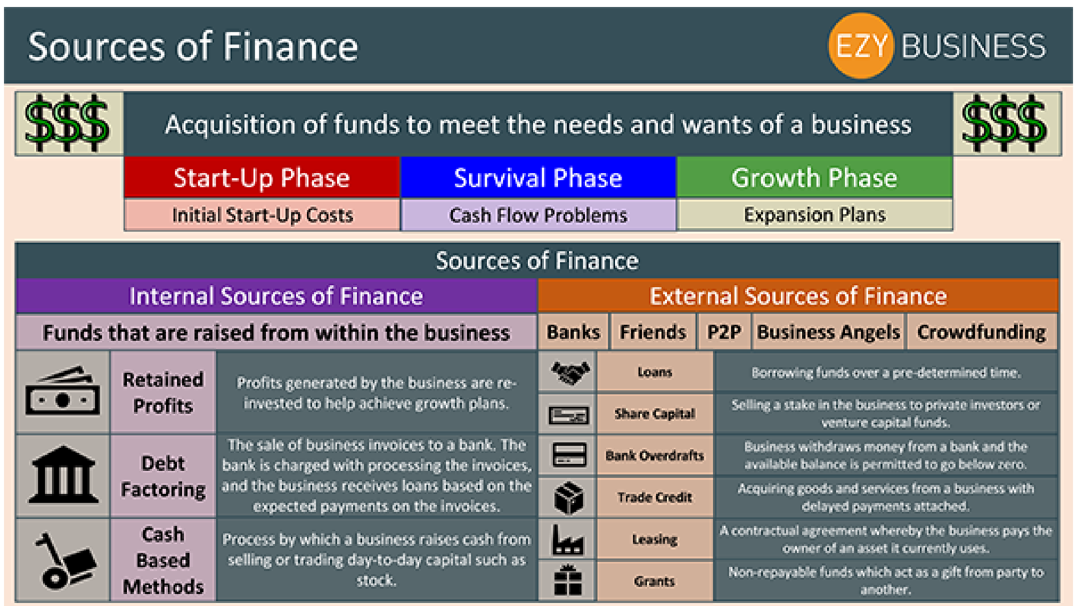
1.3. Financing the enterprise

Key Terms:

Running Costs
Cash Inflow
Cash Outflow
Internal source of finance
External source of finance





Net Cash Flow Formula = Total Cash Inflows – Total Cash Outflows

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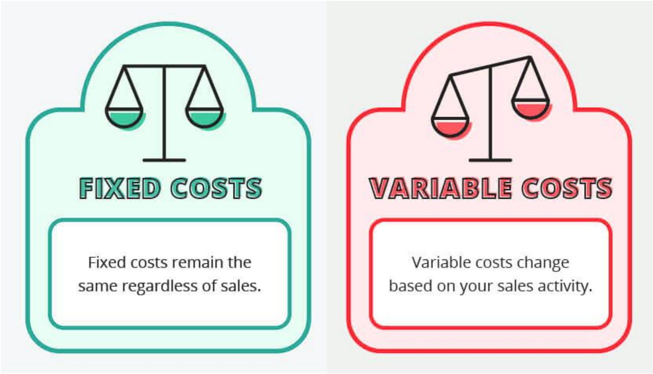
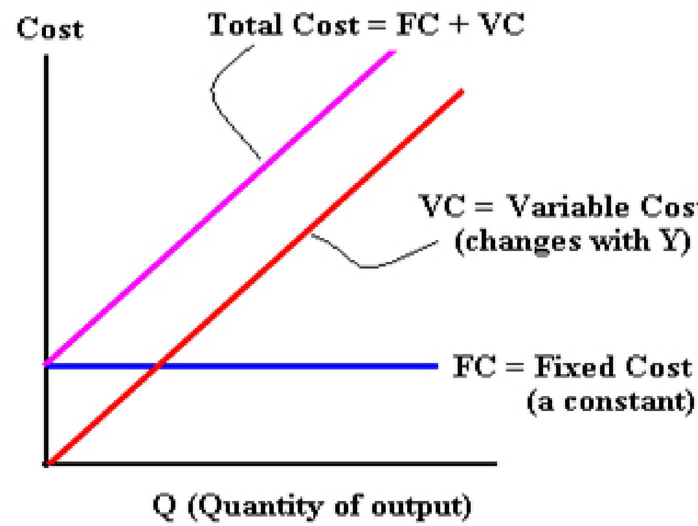
2.1. Cost & revenue



Key Terms:

Variable costs
Fixed costs
Semi-variable costs
Units
Sales revenue
Profit



Sales Revenue

Sales Revenue Formula = Number of Units Sold x Average Sales Price per Unit

Variable Cost (VC) = Cost per Unit + Total Number of Units Produced

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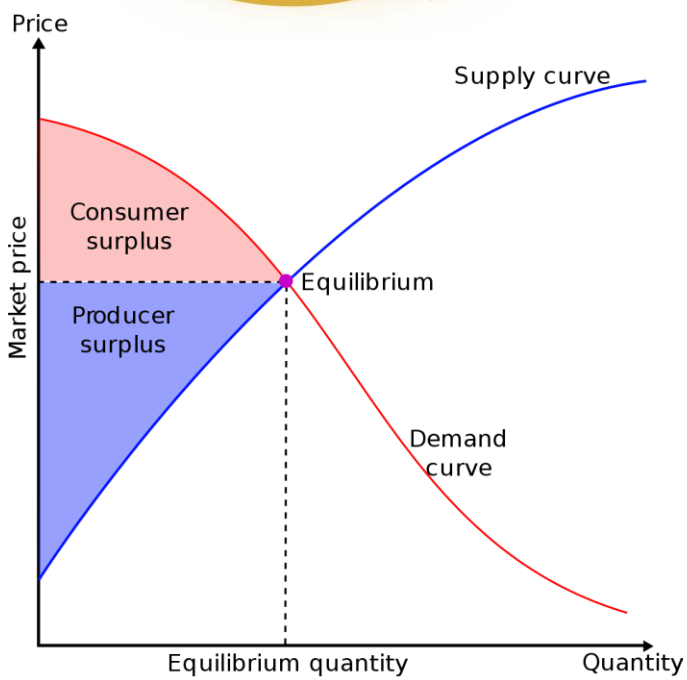
2.2. Making a profit or surplus



<u>Key Terms:</u>

Profit
Revenue
Loss
Surplus
Deficit

PROFIT

- Profit is the surplus of revenue over cost
  - Total Revenue is greater than Total Cost = profit
  - Total Revenue is less than Total Cost = loss
  - TR = TC = break-even i.e. not making a profit or a loss
- Profit/loss = total revenue – total cost
- Surplus/deficit = income - expenditure

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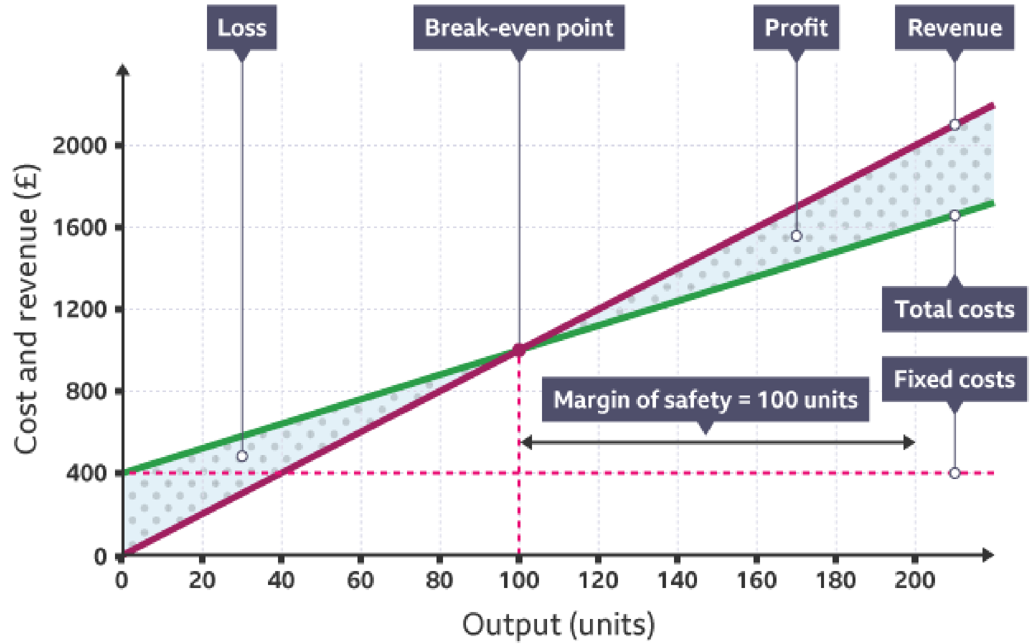
2.3. Break-even

Break Even Point Formula

$$\text{Break Even Point} = \frac{\text{Fixed Cost}}{\text{Selling Price Per Unit} - \text{Variable Cost Per Unit}}$$

$$\text{Break Even Point} = \frac{\text{Fixed Cost}}{\text{Contribution Margin Per Unit}}$$



Break-even is the point at which revenue and total costs are the same, meaning the business is making neither a profit nor a loss.

<u>Key Terms:</u>

Break even point
Fixed costs
Variable costs
Profit
Loss
Margin of safety

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2.4. Cash-flow

The meaning of cash flow

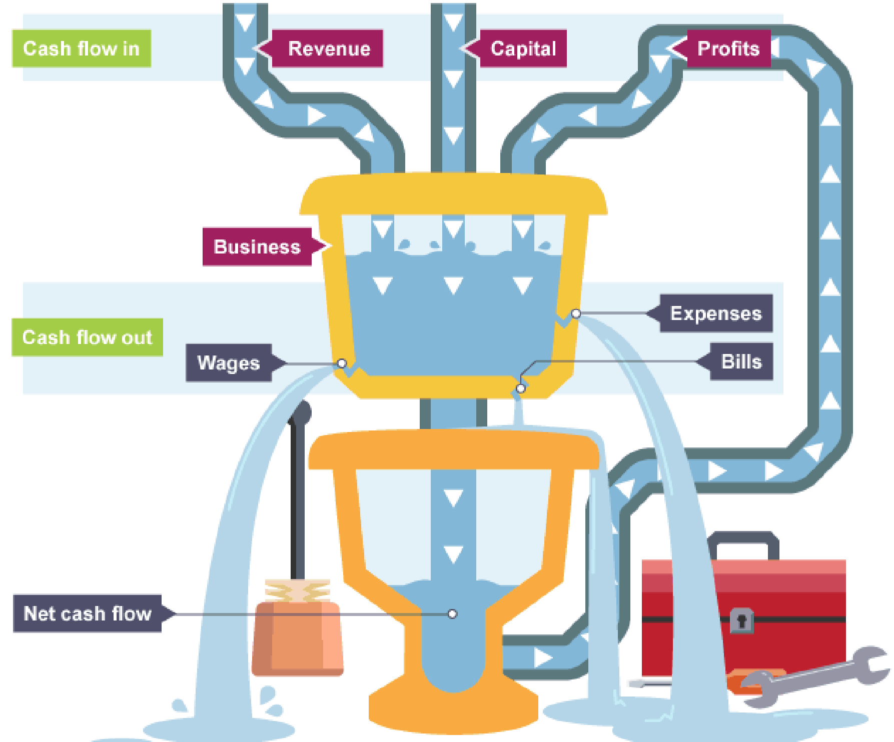
Cash flows into

- Cash sales
- Payments from debtors
- Owners' capital invested
- Sale of assets
- Bank loan

AND out of a business

- Purchasing stock
- Paying wages
- Paying debts – bank loans, creditors
- Purchasing assets

Cash flow is interested in the balance between these cash inflows and cash outflows in terms if their relative size and timings.



Net Cash Flow Formula = Total Cash Inflows - Total Cash Outflows

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3.1. Budgets

BUDGETS

- Budgets are forecasts or plans for the future finances of a business
- These can be for the business as a whole or set for specific functions e.g. a marketing budget
- Budgets can be:
  - Income
  - Expenditure
  - Profit

WHAT-IF ANALYSIS

- What-if analysis is the process of systematically changing variables to calculate a range of possible financial outcomes
- Often used to consider best and worst case scenarios
- Examples of changing variables include:
  - Costs e.g. raw materials or utilities, introduction of the living wage
  - Prices e.g. raise or lower prices in response to competitors actions
  - External economic changes e.g. interest rates payable on a bank loan or taxes

<u>Key Definitions:</u>

Budget: A target amount of money set by a business to be achieved (sales) or adhered to (expenditure) in a specific period of time.

Income budgets: A target amount of money to be received from sales in a given period of time.

Expenditure budgets: A target amount of money a business or function is permitted to spend in a given period of time.

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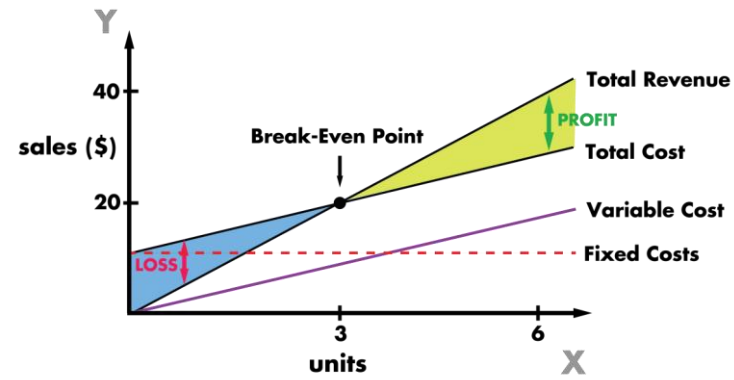
3.2. Using break-even



Key Definitions:

Break-even analysis: A numerical technique used by businesses to identify the number of units necessary to achieve an equilibrium where total costs=total revenue.

Contribution analysis: The process of investigating the effect of changes in selling price and variable costs on the break-even level of output.

Total contribution: The total amount of money contributed first towards fixed costs and then profit from all goods and services sold.

Break Even Point Formula

$$\text{Break Even Point} = \frac{\text{Fixed Cost}}{\text{Selling Price Per Unit} - \text{Variable Cost Per Unit}}$$

$$\text{Break Even Point} = \frac{\text{Fixed Cost}}{\text{Contribution Margin Per Unit}}$$

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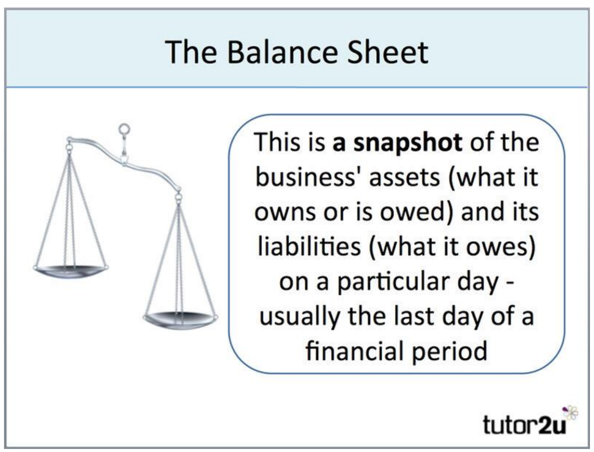
3.3. Interpreting financial information

Key Definitions:

Income statement: A formal financial document that summarises a business' trading activities and expenses to show whether the business has made a profit or a loss in a given period.

Statement of financial position (balance sheets): A formal financial document that summarises the net worth of a business at a given point in time.



Key Term:

Gross profit
Operating profit
Assets
Liabilities
Working Capital
Equity

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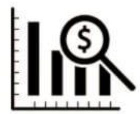
4.1. Interpreting financial ratios

Gross Profit Margin Formula = $\frac{\text{Gross Profit}}{\text{Revenue}}$



Key Term:

Gross profit margin
Operating profit
ROCE
Current ratio
Acid-test ratio
Gearing
Inventory
Trade receivables
Trade payables
Asset turnover

Interpreting financial ratios

- Allows for a more meaningful analysis of published accounts
  - Shows relationship between figures
  - Used for comparisons over time
- Inter and intra business comparisons
  - Intra means between businesses e.g. to compare performance to competitors or to benchmark
  - Inter means within a business e.g. over time within one organisation or between branches

Return on Capital Employed (ROCE)

- A measure of how efficiently a business is using capital employed to generate profits
- Capital employed = total equity + non-current liabilities i.e. all the money invested in the business from:
  - Share capital
  - Reserves
  - Long term loans

- Formula:

<u>Operating profit</u>x 100
Total equity + non-current liabilities

Operating Profit = Gross Profit − Operating Expenses

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4.1. Market Information

Key Definitions:

Market information: Quantitative information about features and trends within a given market.

Market trends: Identifiable patterns in business and consumer behaviour as they change over time.

Market research: The process of gathering and analysing primary or secondary research in order to inform decision making.

Market information

- Scientific decision making will be backed by market information
  - Published accounts of competitors
    - Businesses will compare their own performance with that of their competitors
    - Assess who are the dominant businesses
    - Likely actions of competitors – are they likely to grow or might they downsize?
    - Is there a potential merger or takeover?
    - Assess competitors' performance over time e.g. profitability
    - Assess competitors ability to survive e.g. solvency
    - Assess the internal efficiency of competitors e.g. activity ratios

Decision making

Scientific	Intuition
Supported by quantifiable evidence	Allows for quick decision making
Encourages logical thought process	Encourages innovation and creativity
However:	***However:***
May require expensive data	Difficult to justify
Time consuming	Reliant on experience and expertise

Key Terms:

Market share
Market size
Industry research
Market growth
Published accounts
Scientific & Intuition decision making

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4.2. Stakeholder perspectives

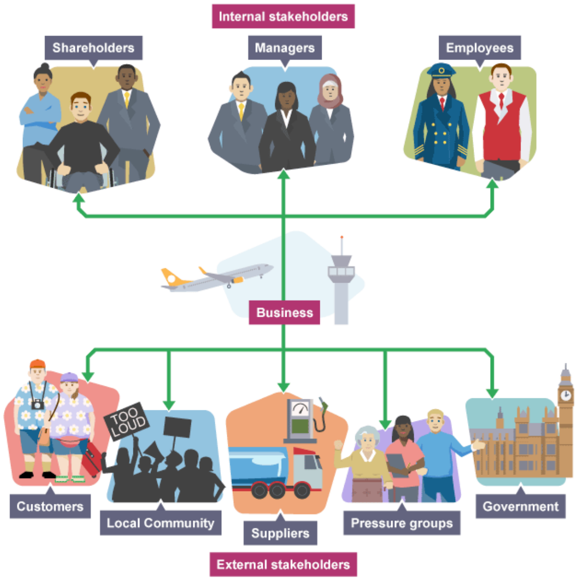
Key Definitions:

Stakeholders perspectives: The requirements, views and aims of each individual or group that is affected by the actions of a business.

Stakeholders: Anyone with an interest in the actions of a business.

STAKEHOLDER PERSPECTIVES

- Different stakeholders will want information to take decisions. Examples include:
  - Owners
    - Return on capital employed – is their investment generating returns?
    - Activity ratios – are managers working effectively?
    - Market trends – should the business invest in growth?
  - Managers
    - Profitability ratios and variance analysis – are expenses being managed?
    - Activity ratios and cash flow – is the business solvent?
  - Potential investors
    - Income statement and statement of financial position to assess business performance
    - Share prices and dividends paid
    - Forecast market trends
  - Suppliers
    - Solvency and activity ratios especially trade payables payment period – should they offer credit? What is the degree of risk involved?



Potential Conflicts between Stakeholders

Business Decision	Likely to be Supported By	Possibly Opposed By?
Cut jobs to reduce costs	Shareholders Banks	Employees Local community
Add extra shifts to increase factory capacity	Management Customers & suppliers	Local community
Introduce new machinery to replace manual work	Customers Shareholders	Employees
Increase selling prices significantly to improve profit margins	Shareholders Management	Customers

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