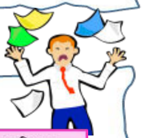
5.1 The Role of the Finance Function

The Finance Function

- To support business planning and decision making
- To provide financial information such as costs, revenue, cash flow

The "jobs" of finance



Jobs of finance:

- Calculating the average rate of return to measure how well the business is doing
- Calculating sales revenue and production costs
- Calculating profit or loss using sales revenue and production costs
- Calculating the break-even output needed to avoid a loss
- Forecasting cash flow – expected revenues and expenditures (costs) to decide if function is needed
- Arranging finance eg from loans or shares
- Managing payments (wages, bills) and receipts of money (form sales)

When will financial information be useful in business decision making?

When a business decides to become more environmentally friendly	There may be increased costs to monitor, it may need extra finance - finance function will provide this
When the business is thinking about changing production methods	A prediction in changes of costs will be needed from the finance function as well as what extra finance will be needed and how the changes might affect cash flow
When the business wants to change the way it markets its products	The finance department would provide information about the costs of these new advertising methods and may need to raise extra finance

Summary

- ➔ The work of the finance functions is important for decision making.
- ➔ The finance function provides financial information about cash flow, spending on markets, break-even, production costs, profits and a comparison of costs.
- ➔ Other departments also influence decision-making – it is all interconnected (relate to interdependent nature of business.

Key Words

Finance

Money raised and used by a business

Finance Function

The area of business that provides financial information such as budgets and cash flow forecasts to support planning and decision making

Financial Information

Includes details of profit, loss, cash flow, profit margin, average rate of return.

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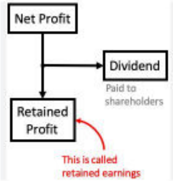
5.2 Sources of Finance

Owner's capital

Advantages
- No need to repay the money
- No interest has to be paid
- No cost to raise the finance ▪ Readily available

Disadvantages
- The owner might not have enough savings to cover the whole finance
- May leave the owner short in personal situations

Retained profit



Advantages
- No interest has to be paid
- No need to repay the money
- No cost to raise the finance
- Readily available

Disadvantages
- Business might not have enough profit to cover the whole finance
- May leave the business short in the future in emergency situations

Loan

Advantages
- Repayment is spread over time
- business knows exactly how much has to be repaid and when
- Money is available quickly

Disadvantages
- Interest has to be paid
- Business may need to risk an asset as security
- Bank will want to see a business plan to ensure they can afford the loan

Issuing shares

Advantages
- A lot of finance can be raised from many investors
- Money does not have to be paid back
- No interest is payable

Disadvantages
- Dividends may have to be paid to shareholders
- Shareholders are entitled to have a say in the running of the business
- The business may be taken over by a competitor

Key Words

Interest

The amount of money that has to be paid back on borrowed money.

Sale of assets

Items sold by the business.

Crowdfunding

Funding a project by raising money from a large number of people who each contribute a relatively small amount, typically via the internet.

Overdraft

An arrangement with the bank allowing a customer to spend more money than they have in their account.

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My Revision Notes OCR GCSE (9-1) p.86.

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My Revision Notes OCR GCSE (9-1) pp.82-86.

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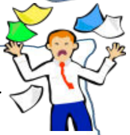
5.3 Revenue, costs and profit

Revenue & Costs

Term	Formulae
(Total) sales revenue	Price x quantity
(Total) variable costs	Variable costs per unit x quantity
Variable costs (per unit)	$\frac{\text{Total variable costs}}{\text{quantity}}$
(Total) fixed costs	Sum of all the fixed costs
Average fixed costs	$\frac{\text{(Total) Fixed costs}}{\text{quantity}}$
Total costs	(Total) variable costs + (total) fixed costs
Profit/loss	Total revenue – total costs

Profit & Loss



Gross Profit - profit made as a result of buying and selling goods or services **without** the day to day costs of running the business.

Net Profit - profit made as a result of buying and selling goods or services **including** the day to day costs of running the business.

Gross profit	Total revenue – cost of sales
Net profit	Total revenue – cost of sales - expenses

Profitability Ratios

Calculations using financial data to measure the performance of a business.

Gross profit margin	$\frac{\text{Gross profit}}{\text{Total revenue}}$
Net profit margin	$\frac{\text{Net profit}}{\text{Total revenue}}$

Average Rate of Return (ARR)

The average annual rate of return (profit) on an investment.
When a business invests in new equipment they want to know what the return is likely to be. Is it worthwhile investing in the new equipment?

Term	Formulae
Total profit from the investment	Total income received from an investment over a given period of time – cost of the investment
Average profit from the investment	$\frac{\text{Total profit from the investment}}{\text{Number of years}}$
Average rate of return	$\frac{\text{Average profit from the investment}}{\text{Cost of the investment}}$

Key Words

Finance Function – The area of business that provides financial information such as budgets and cash flow forecasts to support planning and decision making

Financial Information – Includes details of profit, loss, cash flow, profit margin, average rate of return.

Revenue – Also called **Turnover, Income** and **Sales.** This is the money generated from selling your products

Fixed costs – costs that do not change as the level of production changes. They must be paid even if output/sales are zero, e.g. rent, rates

Variable costs – costs that change in direct relation to the amount sold or produced by a business, e.g. raw materials, packaging

Total costs – All costs added together

Profit – when revenue is greater than costs

Loss – when revenue is lower than costs

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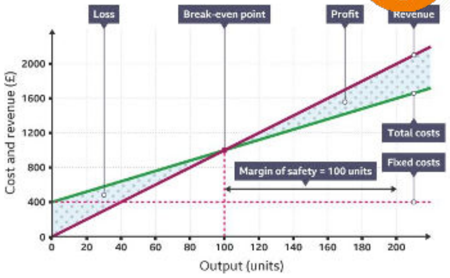
5.4 Break Even

What is break even?

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**.



Simple calculation of break-even quantity

Drawing a break-even graph can be time-consuming, but there is a simpler way to calculate the break-even quantity:

$$Break - even = \frac{fixedcosts}{sellingprice - variablecost(perunit)}$$

The result of this calculation is always how many products a business needs to sell in order to break even.

Usefulness of break-even in business decision making

★ **New products** – break-even can be used to predict how many units would need to be sold, and the business can judge whether this would be realistic.

★ **Pricing** – break-even can be used to see how different pricing strategies might affect the break-even point.

★ **Costs** – break-even can highlight the impact of changes in either fixed or variable costs.

★ **Production levels** – knowing how many units need to be sold in order to make a profit can help a business to plan production levels.

Limitations of break-even in business decision making

Break-even often uses forecasted figures and assumes that the business can sell the units that it produces. there are a number of things that might affect the forecasted break-even point.

➔ **Marketing activities** – any marketing activities that involve price reductions will affect the total revenue received.

➔ **Changes in costs** – the costs used to calculate the break-even point may not be accurate if they are based on forecasts.

➔ **Changes in external factors** – a change in things beyond the control of a business can also affect the usefulness of break-even.

Key Words

Break Even Point

The break-even point occurs where: total revenue = total costs

Break Even Level of Output

The number of units that a business needs to sell in order to cover their total costs from their total revenue

Margin of Safety

The margin of safety is the difference between the current output level and the break-even point.

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5.5 Cash and Cash Flow

What is cash?

- Cash is different to profit; profit is the money left over when costs have been paid.
- Cash is vital to a business' operations. A business may have made a large number of sales but could still become 'insolvent' if it doesn't have enough cash to pay its short term debts and expenses.

Calculating and monitoring cash flow

cash inflows – all the money coming into the business, which can be separated into different categories e.g. sales, rent received and loans

cash outflows – all the money moving out of the business to pay for its costs e.g. suppliers, employees and overheads

The importance of cash flow.

- ★ **Cash flow** refers to money coming in and out of a business. If more goes out than is coming in a business could be in trouble – especially if this is for a long period.
- ★ When a business has just a few large customers and they fail to pay on time, the business' **cash flow position** is badly affected because the business does not have money it was expecting to have.
- ★ A **cash flow forecast** is used to know when a business might have too much or too little money, important so that plans can be made for the future of the business..

Cash Flow Forecasts

	Aug	Sept	Oct
Opening Balance (= Last months closing balance)	1000	1300	2000
Total Inflows	500	800	700
Total Outflows	200	100	500
Closing Balance (= Opening Balance + inflows - outflows)	1300	2000	2200

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Key Words

Cash Flow Forecast

A statement showing the expected flow of money into and out of a business over a period of time.

Negative Cash Flow

Is when during one month, more cash is flowing out of the business than is going in. Sometimes called a cash flow deficit.

Positive Cash Flow

Is when, during one month, more cash flow is flowing into the business than going out. Sometimes called a cash flow surplus.

Liquidity

Is the ability of a business to pay its short-term debts which must be paid in the near future..

Net Cash Flow

Is the total inflow minus total outflow.