Finance and accounting (AS)

Why businesses need finance, capital and revenue expenditure, sources of finance, cash-flow forecasts and managing cash flow, fixed and variable costs, break-even analysis, and budgets and variance analysis.

5.1 Business finance

Finance is needed to **start up**, **operate day to day** (working capital), **grow** and **replace assets**.

	Meaning	Example
Capital expenditure	spending on **non-current (fixed) assets** that last more than a year	machinery, buildings, vehicles
Revenue expenditure	spending on **day-to-day running costs**	wages, materials, rent, electricity

Working capital is the **finance for day-to-day operations** (current assets minus current liabilities). Too little means the business cannot pay bills even if profitable (**liquidity** problems).

> **Revenue (sales turnover) = selling price × quantity sold. Profit = revenue − total costs. Profit is not the same as cash.**

Business failure from lack of finance: a business that cannot pay its debts may face **bankruptcy** (an individual or partner declared unable to pay), **liquidation** (the business is closed and its assets sold to repay creditors) or **administration** (an outside administrator runs the business to try to save it or sell it). **Managing working capital** means collecting **trade receivables** (money owed by customers) promptly and managing **trade payables** (money owed to suppliers) so cash is available.

Short-term and long-term finance

Short-term finance (under a year: overdrafts, trade credit, factoring) pays for **working capital** and day-to-day costs; **long-term finance** (loans, shares, retained profit) pays for **capital expenditure** and **growth**. Matching them matters: using a **short-term overdraft to buy a building** risks a cash crisis when it is recalled.

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5.2 Sources of finance

Internal sources

- **Retained profit:** profit kept in the business: **no cost or interest**, but limited and slow.
- **Owner's investment:** the owner puts in **personal funds**, with no interest but at **personal risk**.
- **Sale of unwanted assets** and **sale and leaseback** (selling an asset such as a building and **renting it back**): raises cash quickly but may reduce capacity or add rent.
- **Working capital management:** reduce inventory or collect debts faster.

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External sources

Source	Time scale	Features
Overdraft	short	**flexible**, interest only on what is used; **can be recalled**
Trade credit	short	delay paying suppliers; **free** unless discounts are lost
Bank loan	medium/long	**fixed repayments**, **interest** and sometimes **security**
Debentures / bonds	long	long-term loans with fixed interest
Mortgage	long	**long-term loan to buy property**, secured on it
Leasing	medium	**rent an asset** instead of buying; no big outlay, but total cost higher
Hire purchase	medium	**buy an asset by instalments**, owning it after the last payment; spreads cost but carries interest
Debt factoring	short	sell **unpaid invoices** to a factor for **immediate cash** (less a fee)
New partners	permanent	extra **capital and skills** from partners, but profits and control are **shared**
Micro-finance	short/medium	**very small loans** to people and tiny businesses who cannot use banks, mostly in developing countries
Share issue	permanent	new capital with **no repayment**; **dilutes control** and brings **dividends**
Venture capital	long	investors take **a stake**; can **bring expertise** but give up ownership
Crowdfunding	varied	many small investors via a website
Government grants	varied	no repayment; conditions

Choosing finance depends on **cost** (interest and charges), **amount** needed, **how long**, **legal form** (only a plc can sell shares to the public), **risk** and **control** the owners want to keep. **Match** the source to the purpose: **short-term** finance for working capital, **long-term** for fixed assets.

5.3 Forecasting and managing cash flows

Cash flow is the **movement of cash into and out of a business**. A **cash-flow forecast** estimates **cash receipts and payments** over time.

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Row	Meaning
Cash inflows	sales receipts, loans, **investment**, asset sales
Cash outflows	purchases, wages, rent, loan repayments
Net cash flow	**inflows − outflows** in the month
Opening balance	cash at the start (the previous closing balance)
Closing balance	**opening balance + net cash flow**

Closing balance = opening balance + net cash flow. Opening balance $4,000, inflows $18,000, outflows $21,000: net = −$3,000, closing balance = $1,000.

A **profitable** business can still **run out of cash** (it may wait for customers to pay while still paying suppliers and wages). Cash flow forecasts help **plan borrowing**, **show lenders**, **spot shortages** and **control spending**. Their limits: they are **estimates** that can be wrong (sales are hard to predict) and **external changes** upset them.

Improving cash flow: chase debtors, **negotiate longer credit** from suppliers, **reduce inventory**, **sell assets**, use an **overdraft or factor** invoices, **cut costs or delay spending**, **offer discounts** for quick payment.

5.4 Costs

Type	Meaning	Examples
Fixed	**do not change** with output in the short run	rent, insurance, salaries
Variable	**change with output**	raw materials, piece-rate pay
Total costs	fixed + variable	
Direct	traced to a **product**	materials, direct labour
Indirect (overhead)	**not traced** to one product	rent, admin

Total cost = fixed cost + variable cost. Average (unit) cost = total cost ÷ output. With fixed costs $40,000 and variable $6 per unit, 10,000 units cost $100,000: average cost $10.

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Break-even analysis

Break-even is the **level of output at which total revenue equals total cost** (no profit, no loss).

> **Contribution per unit = selling price − variable cost per unit. Break-even output = fixed costs ÷ contribution per unit. Margin of safety = actual (or budgeted) output − break-even output.**

Example: price $20, variable cost $12, fixed costs $24,000. Contribution = $8. Break-even = 24,000 ÷ 8 = **3,000 units**. If sales are 4,000, margin of safety = **1,000 units**. Profit = 1,000 × $8 = **$8,000**.

Break-even chart: the **revenue line** and **total cost line** cross at break-even; below it there is a **loss**, above it a **profit**. **Uses:** help set **prices and targets**, assess whether a **loan** is needed, show the **effect of changes** in costs or price. **Limitations:** assumes **all output is sold**, a **constant selling price**, **straight-line** cost and revenue and **one product**; costs and prices actually change.

Full and contribution costing

Full (absorption) costing gives each product a share of **all costs**, including overheads, so the **full cost of each unit** is known; it is useful for **pricing** and the accounts, but the **allocation of overheads is arbitrary**. **Contribution costing** looks only at **selling price − variable cost** (the **contribution**) and does not share out fixed costs; **total contribution − fixed costs = profit**. It helps with decisions such as whether to accept a **special order** at a lower price: accept if **price exceeds variable cost** and there is **spare capacity**. Limits: it ignores fixed costs, so a firm that only covers variable costs **will not make a profit** in the long run.

Using cost information

Accurate cost information is needed to **set prices**, **decide whether to accept an order**, **find where costs can be cut** and **judge profit**. **Average cost** = total cost ÷ output; **marginal cost** = the extra cost of one more unit. Costs are used to **monitor performance** (**actual versus budgeted cost**, profit = revenue − costs) and to improve it, for example by **cutting waste** or **renegotiating supplier prices**.

5.5 Budgets

A **budget** is a **financial plan for the future** (sales, costs, profit, cash). Uses: **plan and set targets**, **control and monitor** performance, **allocate resources**, **motivate** and **co-ordinate** departments.

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Type	Description
Income budget	forecast sales
Expenditure budget	planned spending
Profit budget	forecast profit
Incremental	**last year's budget adjusted** by a % for inflation or expected change: simple, but may repeat past waste
Flexible	**changes with the actual level of output or activity**, so variances are fairer
Zero-based (zero budgeting)	each year starts at **zero** and **every item must be justified**: removes waste, but takes time

Variance analysis

Variance = actual − budget. Favourable (F): profit is **higher** than planned (higher revenue or lower costs). **Adverse** (A): profit is **lower** (lower revenue or higher costs). Investigate the **cause**: poor forecasting, price changes, wage rises, changes in demand. Managers then **adjust**.

> **Variances are measured against the budget. Budgeted costs $50,000, actual costs $54,000: variance $4,000 adverse. Budgeted sales $100,000, actual $96,000: variance $4,000 adverse.**

Advantages of budgeting: control, direction, **motivation**, early warning. **Disadvantages:** the **time to set**, **inaccurate forecasts**, **inflexible** budgets, **conflict** between departments over limits.

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