Section 3.5

DECISION MAKING TO IMPROVE FINANCIAL PERFORMANCE

THIS SECTION OF THE SPECIFICATION COVERS:

- ❑ Setting financial objectives
- ❑ Analysing financial performance
- ❑ Making financial decisions: sources of finance
- ❑ Making financial decisions: improving cash flow and profits

0 1 GIVE ME THREE…

Financial objectives:

1	Revenue
2	Cash flow
3	Capital structure

Internal and external influences on financial objectives:

	INTERNAL INFLUENCES	EXTERNAL INFLUENCES
1	Objectives of the firm as a whole	Competitor's actions
2	Available resources	Economic environment
3	Nature of the product	Legislation

0 2 WHAT'S THE DIFFERENCE?

What's the difference between:

PROFIT AND PROFITABILITY

- ➢ Profit is an absolute figure i.e. sales revenue – total costs = profit
- ➢ Profitability measures an organisation's financial performance; it compares profits with another factor, such as revenue or capital employed

PROFIT AND CASH FLOW

- ➢ Profit is gained when total revenue is greater than total costs

- Cash flow refers to the money flowing into and out of a business i.e. the timings of money paid out by the business and the timings of money received by the business during a specific time period
- A business can survive in the short term without generating a profit; however, if its cash flow is poor, it may struggle to pay its day-to-day bills which may threaten its survival

CAPITAL STRUCTURE AND CAPITAL INVESTMENT

- Capital structure is the way a business has raised the funds required to run operationally and to finance growth; it comprises of long term liabilities and share capital
- Capital investment is the amount of funds that are used to purchase non-current assets

0 3 WHAT IS MEANT BY?

Write a definition for the following key terms:

ADVERSE VARIANCES	FAVOURABLE VARIANCES
• When the difference between the actual and budgeted figure has a negative impact on profit i.e. profits are lower than forecast	• When the difference between the actual and budgeted figure has a positive impact on profit i.e. profits are higher than forecast
BUDGET	**BREAK-EVEN**
• Forward financial plan	• Point where the business is not making a profit or loss; when total revenue = total costs

0 4 TELL ME

The value to a business of:

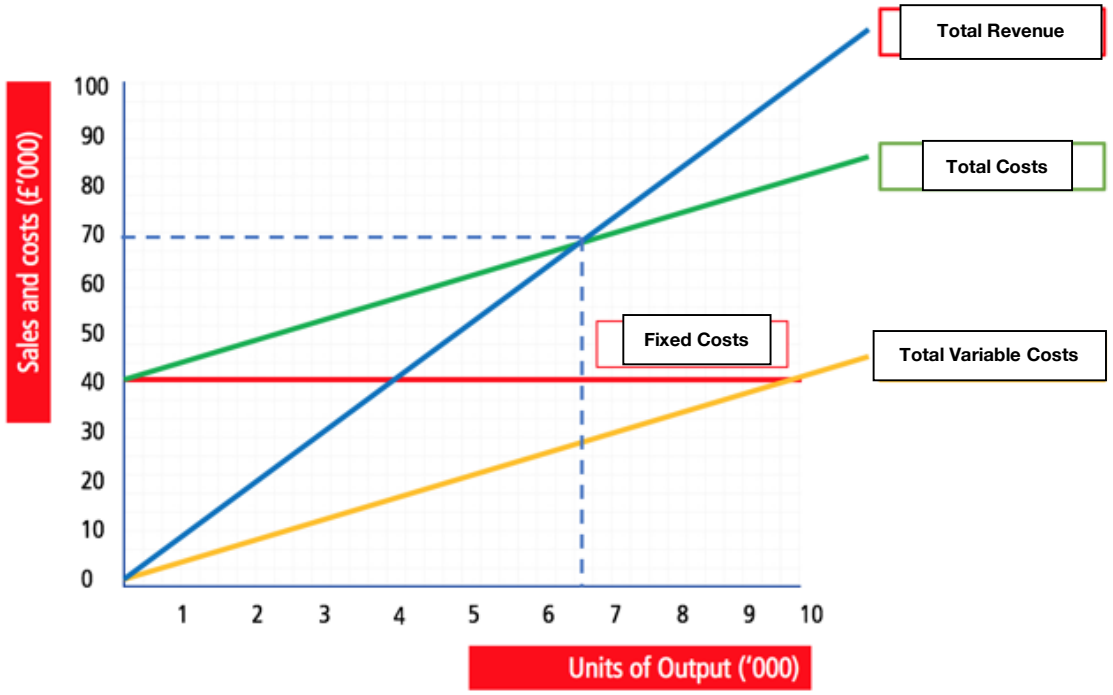
BUDGETING	**Advantages:** ➢ Assists in the control and monitoring of finances ➢ Variance analysis can be conducted that informs decision-making ➢ Departments over budget are easily recognised and corrective action can then take place ➢ Income budgets can provide targets to exceed ➢ Budgets can have a motivational effect through delegation **Disadvantages:** ➢ Based on predictions and assumptions ➢ The effect of unexpected changes on figures ➢ Junior managers will require training increasing costs ➢ Managers with influence may achieve a higher budget ➢ Decisions may be made on budgets which may damage customer relations

BREAK-EVEN ANALYSIS	**Advantages:** ➢ Simple technique which can easily be understood ➢ It shows the number of units a business needs to sell in order to start making a profit ➢ "What if" analysis can be conducted i.e. by changing different variables, the business can see the impact on the break-even point ➢ Used to help support an application for a bank loan ➢ Can help to determine whether a new business idea is viable **Disadvantages:** ➢ One product one selling price ➢ Straight line variable and fixed costs ➢ Assumes all output which is made is sold ➢ The model is static ➢ Poor quality data will make the results inaccurate

0 5 LABEL THE DIAGRAM

Complete the diagram:

BREAK-EVEN CHART



0 6 WHAT'S THE FORMULA?

Write the formula for calculating:

BREAK-EVEN OUTPUT	CONTRIBUTION PER UNIT
Fixed costs / Contribution per unit	Selling price per unit – variable cost per unit
MARGIN OF SAFETY	**TOTAL CONTRIBUTION**
Actual level of output – break-even level of output	Total sales revenue – total variable costs **OR** Contribution per unit x output

0 7 GIVE ME THREE…

Ways of reducing the break-even output of a business:

1	Increasing selling price per unit
2	Lowering fixed costs
3	Lowering variable cost per unit

0 8 WHAT'S THE FORMULA?

Write down the formula for calculating:

GROSS PROFIT	GROSS PROFIT MARGIN
Sales revenue – cost of sales	Gross profit x 100 / Sales revenue
PROFIT FROM OPERATIONS	**PROFIT FROM OPERATIONS MARGIN**
Gross profit – operating expenses	Profit from operations x 100 / Sales revenue
PROFIT FOR THE YEAR	**PROFIT FOR THE YEAR MARGIN**
Profit from operations + profit from other activities – net finance costs - tax	Profit for the year x 100 / Sales revenue
RETURN ON INVESTMENT	

Return on investment (£) x 100
Cost of investment (£)

0 9 CATEGORISE THESE

Place these sources of finance in their correct category of either internal or external:

Retained profits | Crowd funding | Debt factoring | Overdraft | Loans | Share capital | Venture capital

INTERNAL SOURCES OF FINANCE	EXTERNAL SOURCES OF FINANCE
• Retained profits	• Crowd funding • Debt factoring • Overdraft • Loans • Share capital • Venture capital

1 0 BENEFITS AND DRAWBACKS

Identify one benefit and one drawback of:

	BENEFIT	DRAWBACK
DEBT FACTORING	• Instant availability of cash (usually up to 80% of the value of an invoice) • Firm may require a lower overdraft facility	• Typical loss of 5% of the invoice fee to the debt factoring business • Customers may be reluctant to use the firm if they are aware the business is using a debt factoring firm
OVERDRAFT	• Flexible • Easy to arrange • Interest only payable on amount used	• Interest rates are high • Banks can request immediate repayment at any time
RETAINED PROFITS	• No interest payable • Retain control of the business	• Shareholders may receive a lower dividend which may prove unpopular • Funds may be limited and may need to be combined with another source of finance • Loss of interest if profits would be held in an account which pays interest

SHARE CAPITAL	• Does not need to be repaid • Large amounts of capital can be generated	• Only available to companies • Dilution of control of the business from existing owners • Dividends are usually paid limiting the amount available for reinvestment • Existing shareholders must agree to the issue of new shares in a Ltd
LOANS	• Repayments over a specific time period can help with financial planning • Varying amounts can be borrowed	• Interest is added onto repayments • Security is usually required • Inflexible in terms of repayments
VENTURE CAPITAL	• Can take the form of loan or share capital • An alternative to raising funds when other options are difficult to obtain • Possibility to gain expert advice on a business idea	• Possible loss of control over the business • Interest payable on loan capital may be higher than loans from the bank • May only be able to raise small amounts of finance
CROWD FUNDING	• Different options available to raise funds i.e. loan, donation or share capital • Ability to raise small amounts from a large number of people quickly • Use of the internet can raise awareness of project/business	• Time and resources required to build interest in idea • If full amount is not raised, any funds already pledged are usually returned • Issues in terms of copyright, as ideas are seen by many on the internet

1 1 WHAT'S THE DIFFERENCE?

What's the difference between:

CASH INFLOWS AND CASH OUTFLOWS

- Cash inflows: money flowing into or received by the business
- Cash outflows: money flowing/paid out of the business

RECEIVABLES AND PAYABLES

- Receivables is the amount of time it takes customers to pay for its products that a business has supplied on trade credit
- Payables is the amount of time it takes a business to pay its suppliers or other creditors for any goods that they have purchased on trade credit

1 2 TELL ME

Ways to improve and possible difficulties when improving:

	WAYS TO IMPROVE	POSSIBLE DIFFICULTIES
CASH FLOW	• Organising an overdraft • Using a debt factoring business • Sale of unwanted assets • Entering a sale and leaseback agreement • Review trade credit periods with creditors/debtors • Hold less stock	• Immediate repayment can be requested/high interest • Customer confidence reduces/debt factoring fees impact profit levels • No longer able to use the asset in the future/depreciation reduces value obtained • No longer own the asset/regular payments required to use the asset • Reducing trade credit with customers may be an unpopular choice and reduce demand/suppliers may be reluctant to offer trade credit terms • May not be able to meet customer demand satisfactorily
PROFITS	• Change the price • Increase sales volume • Decrease costs • Reduce waste/improve quality	• Depends on PED; raising the price may reduce demand; lowering price may impact negatively on customer perception of quality • This may impact on costs lowering profits through increased promotional activity • May result in lower quality products affecting the brand image; redundancies may occur impacting staff morale/reputation of the business • May require heavy investment in training or technology
PROFITABILITY	• Increase the selling price • Reduce costs	• Customers may react negatively to the increase in price, reducing demand; if the fall is significant enough, a reduction in profits may occur, despite the increase in profit margin received on one unit sold • If customers detect a lower quality of service/product then demand may fall, impacting revenue negatively which may reduce profits, despite the profit margin increasing on the sale of one unit