UNIT 3: FINANCE & ACCOUNTS
IB Business Management
Revision Guide

3.1 Sources of Finance

Finance: the process of providing funds for business activities, making purchases or investing

What business activities is finance required for?

- Setting up a business will require start-up capital of cash injections from the owner(s) to purchase essential capital equipment and, possibly, premises.
- Businesses need to finance their working capital
- Business expansion needs finance to increase the capital assets held by the firm – and, often, expansion will involve higher working capital needs.
- Special situations will often lead to a need for greater finance. A decline in sales, possibly as a result of economic recession, could lead to cash needs to keep the business stable; or a large customer could fail to pay for goods, and finance is quickly needed to pay for essential expenses.
- Apart from purchasing fixed assets, finance is often used to pay for research and development into new products

Start-up capital: capital needed by an entrepreneur to set up/start a business

Working capital: capital needed to pay for raw materials, day-to- day running costs and credit offered to customers (working capital: current assets - current liabilities)

Status/size: public limited companies can obtain finance from various sources, whereas sole traders cannot, since sole traders are less well known and smaller (ex. share capital is only possible for public limited companies)

Amount required: for small amounts, firms may consider short-term sources like bank overdrafts but for larger amounts, long-term bank loans or share capital are more appropriate

Flexibility: this is the ease with which a business can switch from one source to another, in some cases business will need additional sources during their trading period (ex: seasonal changes in demand that may require short-term sources of funding), availability of sources in a short period also determines the flexibility

State of external environment: factors that the business has no control of (ex. increased interest rates)

Gearing: this is the relationship between share capital and loan capital. If a company has a large proportion of loan capital to share capital it is said to be **high geared**, while a company that is **low geared** has a smaller proportion of loan capital to share capital. High-geared businesses are viewed as risky by financial institutions and they will be reluctant to lend money to these firms, this means that the businesses will have to seek alternative sources .

3.2 Costs and Revenues

Cost refers to the total expenditure incurred by a business in order to run its operations. (can be fixed or variable and direct or indirect)

Revenue is a measure of the money generated from the sale of goods and services.

-Carrying out a break-even analysis can inform managers of two things:

1. Whether it is financially worthwhile to produce or launch a particular good or service
2. The expected level of profits that the business will earn if all goes according to plan.

Elements (+formulas) of a break-even analysis

break-even quantity: minimum number of products that must be sold so that all costs are covered by revenues

break-even point: there is neither a profit or loss made, business has sold just enough to cover the costs of making the product, happens when total revenue equals total costs. (TR=TC -> P X Q=TFC + TVC **or** FC/Contribution per unit)

break-even revenue: it is the revenue required to cover both the xed and variable costs in order for a rm to break even. At this point the break-even revenue is equal to the breakeven costs. FC/Cont. X price per unit

profit & loss: if the number of items sold is larger than the break-even quantity, then a profit is made. if it is less, then a loss is made. (total revenue-total costs)
*total costs = variable costs + fixed costs

margin of safety: the difference between the actual output and the break-even quantity. It is the range of output over which profit is made. The greater the difference between the break-even quantity and the sales levels, the greater the safety net or the safer a firm will be in its profit earnings. (current output- BEQ)

OR

$$\text{Net book value in Year 1} = \text{Cost of original asset} - (\text{cost of original asset} \times \text{rate of depreciation [\%]})$$

rate of depreciation= percentage fall in the value of an asset over its useful life

Net book value= assets net value (calculated by deducting depreciation from cost of the asset)

The strengths and weaknesses of each method (AO2)

Straight-Line Method

Strengths	Weaknesses
- It is simple to calculate as it is a predictable expense that is spread over a number of years. - It is mostly suitable for less expensive items, such as furniture, that can be written off within the asset's estimated useful life.	-It is not suitable for expensive assets such as plant and machinery as it does not cater for the loss in efficiency or increase in repair expenses over the useful life of the asset. -It is known to inate the value of some assets which may have lost the greatest amount of value in their rst or second years, such as motor vehicles. -It does not take into account the fast-changing technological environment that may render certain xed assets obsolete very quickly.

Reducing Balance Method

Strengths	Weaknesses
-It more realistically matches the cost and revenue of the business. This is because	- It is a more complex method of calculating depreciation compared to the straight-line

Benefits of cash flow forecasts:

●A cash-flow forecast is a useful planning document for anyone wishing to start a business. This is because it helps to clarify the purpose of the business and provides estimated projections for future performance.

● Cash-flow forecasts provide a good support base for businesses intending to apply for funding from financial institutions. This is because they enable the banks to check on the solvency and creditworthiness of the business.

● Predicting cash flow can help managers identify in advance periods where the business may need cash and therefore plan accordingly to source it.

● A cash-flow forecast can assist in monitoring and managing cash flow. By making comparisons between the estimated cash flow gures and its actual figures, a business should be able to assess where the problem lies and seek the respective solutions to solve it.

The relationship between investment, profit and cash flow (AO2)

The following strategies for dealing with cash flow problems: reducing cash outflow, improving cash inflows, looking for additional finance (AO3)

reducing cash outflow

- delaying payment to suppliers