ELSEVIER

UNDERSTANDING FINANCE

FOURTH EDITION

INSTITUTE OF LEADERSHIP & MANAGEMENT

SUPERSERIES

Understanding Finance

FOURTH EDITION

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Contents

Workbook introduction

1 ILM Super Series study links

This workbook addresses the issues of *Understanding Finance*. Should you wish to extend your study to other Super Series workbooks covering related or different subject areas, you will find a comprehensive list at the back of this book.

2 Links to ILM Qualifications

This workbook relates to the following learning outcomes in segments from the ILM Level 3 Introductory Certificate in First Line Management and the Level 3 Certificate in First Line Management.

C3.2 Financial Environment

1. Recognize the importance of financial information for management.
2. Identify the main financial documents needed by the organization, and the information contained in them.
3. Recognize the most significant financial indicators of business performance and their relevance.
4. List the main sources of long, medium and short-term funds for business.

3 Links to S/NVQs in Management

This workbook relates to the following elements of the Management Standards which are used in S/NVQs in Management, as well as a range of other S/NVQs.

B1.1 Make recommendations for the use of resources
B1.2 Contribute to the control of resources
D1.1 Gather required information
D1.2 Inform and advise others.

It will also help you to develop the following Personal Competences:

- focusing on results;
- searching for information;
- thinking and taking decisions.

4 Workbook objectives

As a first line manager, you may be involved in the production or sale of goods, or delivery of services.

Your performance at work, along with that of your work team, determines how well your organization does financially and how successful it is. Whether you work in a business that sets out to make a profit, or in the voluntary sector, your organization is interested in making the best use of the funds it has available. And those who supply the funds, whether they are shareholders, partners or individuals making donations, are keen to see that their money is well used. They obtain that information from year-end financial statements such as a company's annual published report and accounts. Management also needs financial information to help it run the organization day to day, and specific accounts are prepared for its use too.

In this workbook, we will look at what is included in these accounts, what they tell us and how they are used. We'll explore the way money is used in a business, and look at how performance can be measured in financial terms. Financial constraints are often very important to organizations; developing your understanding of finances will help you improve your effectiveness in the workplace. You will spot ways in which money can be better used.

Accountancy, like all specialist subjects, has its own language. Just as a car mechanic will talk of 'torque' and 'gaskets', and a computer expert will discuss 'bytes' and 'disk access time', an accountant uses expressions such as 'current liabilities' and 'retained profit'. By the end of this workbook, you will have a better appreciation of accounting vocabulary and this, in itself, will clarify what is meant by aspects of accounts that you may have found confusing and mysterious in the past.

4.1 Objectives

When you have completed this workbook you will be better able to:

- understand how important it is for any organization to have sufficient cash;
- appreciate why it is vital for an organization to control its finances by forecasting and monitoring cash flow;
- identify appropriate providers of finance in given situations;
- make sense of key financial information in profit and loss accounts and balance sheets;
- measure how well an organization is performing financially;

5 Activity planner

If you are compiling a S/NVQ portfolio, you might like to develop some of the Activities in this workbook as evidence of your competence. You may want to look at the following Activities now so that you can make prior arrangements:

Activity 21	Obtain a cash flow forecast for your organization or, if that is not possible, draw one up for a club or society in which you are involved, for yourself and your family.

Activities 31 and 37	Obtain copies of the year-end financial statements of your own organization and two or three others, say, a bank or building society, a club or charity.

Activities that may provide the basis of evidence for your S/NVQ portfolio are signposted with this icon.

The Work-based assignment (on pages 84–6) suggests that you speak to your manager, finance director or to your colleagues in the accounts office about the accounts of your organization.

You might like to start thinking now about who to approach and arrange to speak with them.

Session A
The need for accounts

1 Introduction

Money (or cash, or finance, or funds) is very important to all of us, both as private individuals and as members of organizations. It isn't that it is valuable in itself; its importance is in what it can buy and what it can do for us.

As individuals, once we've paid our tax and national insurance, how we account for our money is up to us. We may keep careful records, or we may decide to spend it while we've got it and, when it's gone, manage without.

Trading organizations, however, must keep detailed and accurate accounts if they are to stay in business at all, and if they hope to plan for the future in any meaningful way. For example, if manufacturers were approached to make a new product but did not have the right equipment to put the product together, they would have to buy new plant and machinery. If they did not know how much cash they had available, what was owing to them and how much they had to pay out in the next few weeks, how could they possibly agree to take on the contract?

There may be other reasons for turning down products than simply shortage of cash. The product might seem to have a limited market, or it might conflict with competing products already being made for other customers. Nevertheless, cash is very often a critical issue.

Let's begin by looking at what money does for us.

2 How money is used

We are so familiar with money that it is easy to take it for granted and not analyse the ways in which we use it. But if you think about it, you will see the following issues.

- **Money acts as a medium of exchange.** Money enables people who make goods to obtain food, clothing and other wares. They sell their goods for money and then use the money to buy the things they need. Money enables them to exchange one thing for another.
- **Money acts as a store of wealth.** Money enables people to save or store money for 'rainy days', holidays, retirement and so on. Money is used to invest for the future.
- **Money acts as a means of deferred payment.** Money allows people to borrow and repay fixed amounts over a certain period. In other words, it allows them to buy something now, and put off or defer paying for it. They buy, say, a television now and pay for it over one or two years.
- **Money acts as a measure of values.** Money allows people to compare totally different things, such as a kilogram of apples and a pair of shoes. It is possible to do this by deciding what each is worth in money terms.

This last use of money, that enables one to apply a common measure of value to widely differing objects, is particularly useful. It means that the things you use at your workplace can be given a value in money terms, or 'costed'.

Many of the activities at your workplace can be costed, including:

- the results of your workteam's efforts;
- the use of machinery and equipment;
- the use of the buildings where you work;
- the use of the materials you work with.

Thus the cost of producing something, or providing a service, can be worked out, by using money as a measure of values. Typically if your work team paints a room, the costs of materials and labour will be added together, an element of profit will be added on and the owner of the room will be charged a price for the job.

Of course, there is a limit to translating everything into its value in money. What is a smile or a friendly word worth, for example?

Try the following questions, before you move on.

Activity 1

10 mins

You have seen that money is used in at least four ways:

a as a medium of **exchange**;
b as a **store** of wealth;
c as a means of **deferred** payment;
d as a **measure** of values.

Decide how each of the following people are using money, by circling the appropriate letter (a), (b), (c) or (d), in each situation described below. Briefly describe the reasons for your selection.

1 John has a car and a house. He decides that together they are worth £175,000. Is he thinking of money in terms of (a), (b), (c) or (d) above?

Briefly explain the reasons for your selection.

2 Jack has won £2,000 on the lottery, and decides to put the money into a building society until he needs it. Is he thinking of money in terms of (a), (b), (c) or (d) above?

Briefly explain the reasons for your selection.

3 Janet borrows £1,000 from her father to buy a car. She agrees to pay the money back at £100 a month over 10 months. Is she thinking of money in terms of (a), (b), (c) or (d) above?

Briefly explain the reasons for your selection.

4 Diana sells her house for £150,000 and buys a smaller house for £130,000 and a car for £20,000. Is she thinking of money in terms of (a), (b), (c) or (d) above?

Briefly explain the reasons for your selection.

Each situation leans towards one choice, although you may have come up with a logical reason for another choice. See how far you agree with my suggestions:

1 A car and a house are so different from each other that John can only group them together if he gives them a money value. So in this case he is using money as (d) a **measure** of values. If John's car was vintage or veteran he might combine the car and house as (b) a **store** of wealth.

You can see that the categories are not always clear cut. Different interpretations are possible.

2 Jack is saving money to use it later, so in this case he is using money as (b) a **store** of wealth. He is also using it as an investment for the future.

3 Janet's borrowing enables her to have the car now and pay for it over a period, so she is using money as a means of (c) **deferred** payment. She will also be exchanging the cash for the car.

4 Finally, Diana is able to exchange one item, her house, for a car and a smaller house. In this case she is using money as (a) a medium of **exchange**.

Whatever the way in which an organization uses money, it will need to record the transactions as proof of how it has used the money for all those interested in its operations.

3 The use of accounting records

Accounting records are kept by individuals, businesses, clubs, charities and non-profit organizations in order to monitor their financial positions. Accounting is the common language of business because it is used to describe the financial dealings of every kind of organization. Accounts are prepared from accounting records using the principles of accounting. We've just examined the way in which money serves a variety of purposes we can look at accounting records, accounting and accounts in the same way.

There are a number of reasons why businesses keep accounting records and prepare accounts. An organization must:

- know what it owes;
- know what it is owed;

- know what it owns;
- be able to examine its activities to ensure that it makes a profit or works within a budget;
- be able to plan for the future.

In addition, certain organizations such as companies, charities and building societies are required by law to keep accounting records and prepare accounts. We will not look at legal requirements in this workbook.

The first three reasons for keeping accounting records are easily achieved by keeping a note of, or monitoring, transactions. The last two reasons are fulfilled by preparing accounts (or financial statements which we will look at later in this workbook).

3.1 Monitoring transactions

Activity 2

5 mins

Suppose you earn £300 per week and are paid at the end of the week. In reality you are owed £60 by the organization for which you work at the end of Monday, another £60 at the end of Tuesday and so on until Friday.

It's the same with the money you owe to others, such as the milkman and the newsagent. You may have milk and newspapers delivered, and pay what you owe at the end of the week, although bills aren't all as simple as this. Let's say that you owed the following amounts:

- Monday £30;
- Tuesday £35;
- Wednesday £45;
- Thursday £40;
- Friday £10;
- Saturday £20;
- Sunday £10.

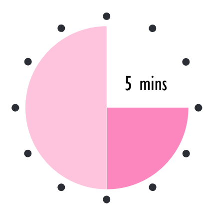
Draw up your weekly account in the following table; the first entry is shown as an example.

	What you are owed	What you owe
Monday	£60	£30
Tuesday		
Wednesday		
Thursday		
Friday		
Saturday		
Sunday		
Totals		

You will know when you have to pay for, say, your rent, as your landlord calls round at the same time each month and you make sure you have the cash available. Businesses do the same, and we will look at the timing of payments later.

The answer to this activity is on page 97.

Activity 3



Haugh Limited owes £3,000 to Punton plc. Haugh Limited does not have enough cash to pay this debt at the moment. However, it is owed £3,000 by people who have bought goods from it on credit.

How can the directors of Haugh Limited decide when they will be able to repay the debt to Punton plc?

The directors of Haugh Limited would want to know when the £3,000 it is owed will be paid. Until the cash comes in from its customers, it will clearly not be available to pass it on to Punton plc. So the directors will need to know the various dates when the cash will be coming in, particularly when the full amount is to be received. The directors can then promise Punton plc that they will be paid after a particular date. Of course, Haugh Limited will then be relying on its customers paying up when they say they will.

Organizations could have a number of debts and be owed money for many sales. This makes it even more important for its accounting records to be accurate so that they can manage to pay debts on time whenever possible.

Activity 4

5 mins

Suppose Punton plc is not happy with the proposals suggested by the directors of Haugh Limited and is pressing for payment. Punton plc wants the £3,000 owed now. What can the directors of Haugh Limited do? Try to think of two things the company might do if it does not yet have the money to pay Punton plc.

There are a number of possibilities you may have suggested, including the following.

- The company could default by not paying what it owes. (Not recommended!)
- It could borrow the money – it would then still owe £3,000, but to the bank, not Punton plc.
- It could sell something it owns – it could sell £3,000 worth of goods, or sell off a piece of land or equipment, for immediate payment so that it can pay the money on to Punton plc.

This suggests that the following are closely connected in the accounting records of Haugh Limited in this case:

- how much is **owned** by the company;
- how much is **owed** by the company;
- how much is **owed** to the company.

This applies equally to all organizations. A care provider must pay employees, business rates and other expenses on time; a charity may need to finance a homeless shelter by a specific date. And you can imagine the effects of the cash not being available at the right time on the customers and clients of such organizations.

3.2 Working to a budget

Now let's look at our fourth reason why a company keeps accounting records: to be able to examine its activities to ensure that it makes a profit or works within a budget. Again we'll take an example.

Activity 5

3 mins

Suppose your take-home pay this month is £1,000 and you have to make the following payments:

- housekeeping £400;
- mortgage £300;
- insurance £100;
- car loan £250.

It's clear that you don't have enough money to meet all your monthly payments. You are going to be short by £50.

From our last activity we know you could try to borrow the £50, or you could default on one of your payments, but this would be foolish! Next month, you'd have a worse problem – you would be £50 short again and also owe £50.

Make a brief note of how you might deal with this problem.

____

____

____

It seems apparent that your income must rise or your spending must be reduced. You could do this by, for example:

- selling your car – if it covers the outstanding loan;
- cancelling your insurance – or changing to cheaper cover;
- cutting down on housekeeping;
- remortgaging so as to get a better rate of interest.

In order to avoid long-term debt your income must exceed your expenditure, and the same applies to any organization. In the long term no organization can survive if the money it receives – whether this be from sales, grants or, even a donation from those who distribute the funds of the National Lottery – is less than the money it spends.

3.3 Making a profit

We can see that an organization cannot survive unless it has enough income to pay its expenses. So the fourth reason why a business must keep accounting records is to enable it to examine its day-to-day activities to ensure that it makes an excess of income over expenditure – known as a profit – or at least works within its budget.

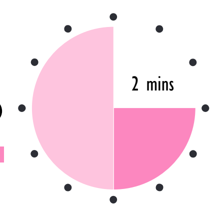
Profit = Total income – Total expenditure

Organizations that do not make a profit will need to ensure that at the worst:

Total income = Total expenditure

This ensures survival. Often non-profit organizations will want to make a surplus, which is their equivalent of a profit. The difference is they don't usually have shareholders to pay dividends to, so the surplus is money for a 'rainy day'.

Activity 6



Suggest a couple of additional reasons why an organization should wish to make a profit or surplus.

There are various possibilities you may have suggested, such as:

- to provide money to pay out to the owners as a reward for financing a business;
- to build up money to replace equipment and machinery as it wears out;
- to help the organization expand.

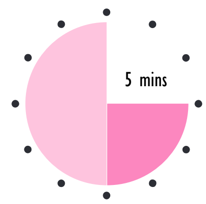
3.4 Planning

Suppose your monthly take-home pay is £1,000 and your monthly expenses are £950. This enables you to save £50 per month. Next year, you may want to go abroad on holiday, which will cost you £850. However, in the next twelve months you can only save £600.

In the same way, an organization's plans have to be based upon realistic forecasts of the money it will have available. And you saw from the last activity how important generating profits is in helping to put plans into action.

This is the fifth reason for keeping accounting records: to make it possible to plan for the future in a practical way.

Activity 7



Amos Phiri expects his business to generate a profit of £42,000 in the next year and there are several ways he could deal with the profit:

1 he could pay his employees a bonus of 10% of their annual wages, which will cost £36,000;

2 he could buy himself a BMW car for £38,000;

3 he could purchase new machinery for £40,000 which it is expected will generate a further £10,000 profit each year;

4 he could keep all the profit in the bank in a deposit account just in case the business is less successful in the future.

Write down one point for and one point against each of the above possible courses of action.

1 For ________________________

Against ________________________

2 For ________________________

Against ________________________

3 For ____

Against ____

4 For ____

Against ____

There are a number of points you may have suggested. For instance, a bonus to employees might well encourage loyalty and retain staff, and they might work harder for Amos. But they might expect to receive a bonus in future years, and even include an amount for a bonus in their annual household budget. Or, they may feel that it would be better to include the amount in wages in future. Much depends on the present relationship between Amos and his employees.

As the business belongs to Amos, he would be within his rights to take out the money and buy a BMW. Clearly this would benefit him. But this might well cause resentment among the workforce who helped to generate the profit.

In both of the first two examples, money is going out of the business for good, and if the next year is not as successful, this could mean it gets into financial difficulties without anything to 'fall back on'.

The idea of purchasing more machinery to generate additional profits is attractive for the business and, if employees see this as a signal of job security, it could be well received by them too. If the plans are successful, there will be more to share out in the future. But, it does mean deferring rewards for employees and the owner to some future time. And both Amos and his workers might like some money now.

Finally, keeping the profit in a bank deposit account would help in case of future financial difficulties. The business would be able to pay its debts even if sufficient money was not coming in day to day. But a greater profit is likely to be made if Amos uses the money in the business than would be obtained from interest paid on a deposit account.

Whenever a business makes plans, there will be disadvantages as well as advantages in each plan. Accounting helps to show the financial effects of the various options. And there is more to think about than purely financial matters, as you can see.

4 Accounting records and accounts

Earlier on we distinguished between accounting records on the one hand, and accounts (or financial statements) on the other. You may be wondering about the importance of this distinction.

Activity 8

1 min

Suppose you help your sister with her market stall business on a Saturday. She keeps a little notebook in which she jots down each transaction as it takes place. She buys her stock from four different suppliers as follows, and pays in cash as noted below:

Supplier A	£100
Supplier B	£250
Supplier C	£50
Supplier D	£175

On Saturday she sells all her goods to ten different customers, noting down the following amounts received in cash: £10, £75, £80, £65, £90, £115, £20, £25, £70, £45, £100.

She also makes a note of paying the market operator £25 cash, and giving you £20 cash for helping her.

Your sister thinks she had a good day. Try to answer this question quickly without using a calculator: did she have a good day?

Unless you have a fantastic head for numbers, you probably couldn't answer this question immediately with any degree of certainty. While your sister's notebook is a form of accounting record for what happened, the numbers don't mean very much listed out separately. What we need is a summary of the different transactions that took place, and this is why we record individual transactions in **accounting records** to produce summary **accounts**.

Using the information from the accounting records that we have been given, we can prepare the following accounts for your sister (for income, stock purchases, stall rent and wages):

Account	*Transactions in accounting records* £	*Total* £
Income	10 + 75 + 80 + 65 + 90 + 115 + 20 + 25 + 70 + 45 + 100	695
Expenditure:		
Stock purchases	100 + 250 + 50 + 175	(575)
Stall rent	25	(25)
Wages	20	(20)
Profit for the day		75

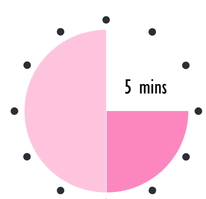
(It is an accounting convention to put amounts that are paid out, or owed, in brackets to show that they are to be deducted from the amounts received.)

So she did have a good day!

4.1 Source documents for accounting records

A business of any size can't hope to jot down its transactions in the way that your sister could for one quiet day's trading on her market stall. Also, notice that all your sister's transactions were settled immediately in cash. What if she hadn't paid immediately for her stock, or if she had agreed to wait for payment by one of her customers? How would these transactions be recorded?

Activity 9



Your sister's market stall has done well recently and she has now rented premises, acquired a till and opened a business bank account. Some customers come in and pay by cash, but most use cheques, or are themselves businesses and ask for credit (that is, a delay between taking the goods and paying for them). She also persuades a few of her suppliers to allow her credit, so she doesn't have to pay immediately in cash for the stock she buys.

What kinds of document would you expect your sister to be dealing with:

For cash sales? ____________________

For cash purchases? ____________________

For sales on credit? ____________________

For purchases on credit? ____________________

What documents will your sister be dealing with if customers pay not in cash but by:

Cheque? ____________________

What documents will she be dealing with if she doesn't pay cash immediately to her suppliers?

____

What documents will she be dealing with when her credit customers settle their bills?

____

You may have had to think quite hard about some of these queries, but you could have come up with the following suggestions:

- source documents for cash sales: till roll, receipts to the customers;
- source documents for cash purchases: receipts (again), but from the suppliers for cash received;
- source documents for sales on credit: bills, or sales invoices from your sister to the customers;
- source documents for purchases on credit: bills (again), or invoices from the suppliers to your sister;
- source documents for receipts by cheque: cheques from customers to your sister;
- source documents for payments to credit suppliers: cheques from your sister to her suppliers.

You'll have noticed that I have called these items 'source documents'. This is because they are the source of the information on each transaction that will be recorded in your sister's accounting records, and which will eventually end up summarized in her accounts.

In the case of receipts given to her customers for a cash sale, and sales invoices to her credit customers, the source documents that your sister will keep in her records are copies of what is given away. She will keep the original of the receipt from her supplier for cash received, and of the invoice received from her supplier (often called a purchase invoice, though for the supplier of course it is a sales invoice). For cheques received from her customers she will have to note the details on a paying-in slip before handing the cheques over to her bank. And for cheques to her suppliers she will have to note the details on her cheque stub or counterfoil in her chequebook.

Activity 10

10 mins

Try to find a copy of an invoice from a business that charges Value Added Tax (VAT). You will know that it is an invoice because it must say so by law. What details does it contain?

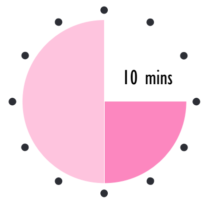
An invoice with VAT has to contain certain information by law, and contains certain other information by convention. You might have noted down:

- supplier name, address and contact details;
- invoice number;
- customer name and address;
- VAT registration number;
- purchase order number or reference;
- delivery note number or reference;
- **date/tax point**;
- details of the goods or services being invoiced;
- charge for each item;
- rate of VAT applied to each item;
- trade, volume or bulk discount applied;
- **net total of goods/services**;
- **VAT amount**;
- **invoice total (often called the gross total)**;
- credit terms, including the period of credit allowed and whether there are any discounts for early payment;
- remittance advice, for sending back with the payment (often this is a bank giro credit form).

As you can see, there's a lot of information, but I've highlighted the most important information from an invoice that has to be entered in the accounting records.

The other important source document for accounting records is the credit note. Your sister would give one of these to her customer if the customer had returned goods to your sister. Similarly, she would receive a credit note from a supplier to whom she had returned goods.

Self-assessment 1



1 Complete the following statements by writing a suitable word or words in the space provided.

A company keeps accounting records because it needs to:

a know how much it __________________ to other people;

b know how much it is __________________ by other people;

c know the value of what it __________________ ;

d know what changes need to be made if the money coming into the business is less than the amount __________________ to other people;

e be able to __________________ for the future.

2 Match each of the following four ways of using money with the **most** appropriate example.

a Medium of exchange.	(i) Buying a bus ticket.
b Store of wealth.	(ii) An antique clock is valued at £750.
c Means of deferred payment.	(iii) Contributing to a pension plan.
d Measure of value.	(iv) Buying a coat using a credit card.

3 a State how the surplus or profit of an organization is calculated.

____

____

b Give **two** reasons why a business needs to make a profit.

____

____

4 a Why are source documents important for accounting?

b What is the key information contained in:

1 a sales invoice?

2 a purchase invoice?

3 a cheque?

Answers to these questions can be found on page 93.

5 Summary

- The uses of money are as:
  - a medium of exchange;
  - a store of wealth and investment for the future;
  - a means of deferred payment (delayed payment over a period);
  - a common measure of value.

- Organizations keep accounting records to show:
  - how much they owe;
  - how much they are owed;
  - the value of what they own.

- Accounting records enable an organization to monitor day-to-day activities, in order to ensure that expenditure is kept below income. Without this monitoring and control, it would not be possible for the organization to make plans or, in the long term, to survive.

- Accounting principles are used to prepare accounts (or financial statements) from accounting records.

- Source documents, such as receipts for cash paid and received, invoices and cheques, provide key information on the amounts to be recorded for each transaction entered into by an enterprise. Accounting records allow us to record these individual transactions. Accounts are prepared from accounting records and summarise all the individual transactions.

Session B
Finance in business

1 Introduction

You have seen that a business needs to make a profit in order to survive and grow. It also needs start-up money. Where does this money come from? How is it used? How is it controlled so that it can be used at the right time and in the right way?

We constantly hear about the high salaries and salary increases enjoyed by those in charge of very powerful organizations, such as banks. Such salaries are needed to keep the best people at the top and to ensure that the organizations continue to make large profits. Do you agree? Or is ensuring that shareholders are well rewarded the best way for a business to use its profits for the future?

We will aim to answer those questions by the end of this session. You will also see how money can be obtained in different ways and how it is spent to benefit organizations in the short term and longer term. You can also develop your skills so that you will be better able to assess how much of the money generated by businesses is passed on to owners, directors and shareholders, as compared with being reinvested for growth.

We will also look at accounting for cash, which is so necessary to ensure survival.

2 How a business works

2.1 Business capital

Any business needs money to begin. Someone who sets up a cleaning service will need to pay for cleaning materials and, perhaps, advertising. A self-employed editor will need to pay for a computer, modem and printer at the very least. The permanent money used in a business is referred to as **capital** or **capital employed**. In a company, which is a particular legal form for a business, capital is provided in the form of **share capital**; the shares that make up the total share capital are purchased for cash by **shareholders**.

Activity 11

10 mins

George and Mary would like to open a seaside cafe and are wondering what they could use for the opening capital. Which of the following might provide capital? Tick the appropriate box(es).

- Their savings. ☐
- A loan from a bank. ☐
- A gift from an uncle (or other relation). ☐
- Cash from selling a share in the business to someone else. ☐
- George's redundancy money from his last job. ☐

Briefly explain why you might prefer one choice rather than the others.

Any of these sources might be acceptable, although it might be difficult to sell a share in a business that does not yet exist. Setting up in business is risky so George and Mary are likely not to want to use money they might need in the future, or that would involve difficulties with others if the cafe is not successful. So the best choices are probably savings and George's redundancy money, so long as some money remains for them in the event of failure. Providing the gift has 'no strings attached', this may be an even better choice. There would be a legal or moral liability to repay any loan, so if the cafe is unsuccessful George and Mary might not only lose the business but also have to repay the bank or an outsider.

Funds from the owner's own savings and gifts they receive are known as **owner's capital**. Loans, such as from a bank, are called **loan capital**. Accountants might say that a loan is not capital because it needs to be paid back to someone outside the business. They would call it a **creditor**. In practice you will hear both terms used for loans.

2.2 Using capital

If George and Mary use their savings as owner's capital, how would they use it?

Activity 12

5 mins

Look at the following list of items. Tick those which you think George and Mary might need.

- A building to work from. ☐
- A car or van for distribution. ☐
- Cash till. ☐
- Some form of machinery. ☐

In the space below, write down any other items you think may be needed.

They will need a building for the cafe, which they may buy or rent, cooking equipment, perhaps an ice cream machine, tables and chairs, a cash till and a serving area. A car or van are probably not needed in a business like this. You may have thought of other examples.

Fixed assets usually stay in an organization for more than a year.

A building, a car or van, equipment and other purchases of this kind will be bought with the intention of keeping them. Under normal circumstances they will not be for re-sale. As such, they are known as **fixed assets**.

Activity 13

5 mins

If you start a business and have a building, a car or van, equipment and so on, you can begin work. Or can you? What else does a business need in order to trade? Write down two other things you think you may need.

You may have thought of a number of ideas. Perhaps they included:

- raw materials to be used to make goods with (food, in the case of George and Mary);
- other people to help you in your business;
- fuel, such as electricity.

All these items would have to be paid for. They are the things, and people, that are needed by the business in order to be able to sell goods or services. They are needed day to day and involve the business:

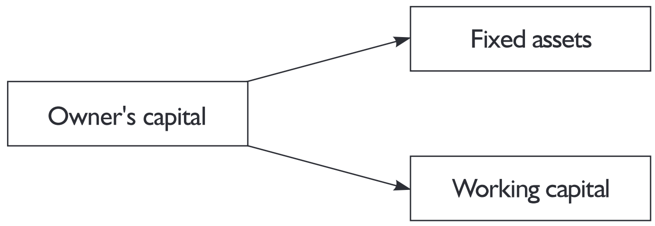
Current assets and current liabilities are used up in an organization within a year.

- owning things like raw materials, which are part of the **current assets**;
- owing money to people such as employees and the electricity company, called **current liabilities** in accounting (they are also known as creditors);
- being owed money by its customers, known as **debtors**, who are also part of the **current assets**.

Current assets and current liabilities are grouped together and are called **working capital**.

So the owner's capital is used to obtain both the **fixed assets** and to provide the **working capital** (see the diagram, 'How owner's capital is used', below).

Working capital is the money circulating around a company. It flows out when it is used to buy materials and to employ people. It flows back in when goods or services are sold and cash is received.



How owner's capital is used

Activity 14

5 mins

You identified various fixed assets that would be used in George and Mary's cafe. Would the following be current assets or current liabilities? Delete the one you think is incorrect.

■ food;	Current asset/Current liability
■ the amount owed to the supplier of the food;	Current asset/Current liability
■ wages of a waitress;	Current asset/Current liability
■ cash in the till.	Current asset/Current liability

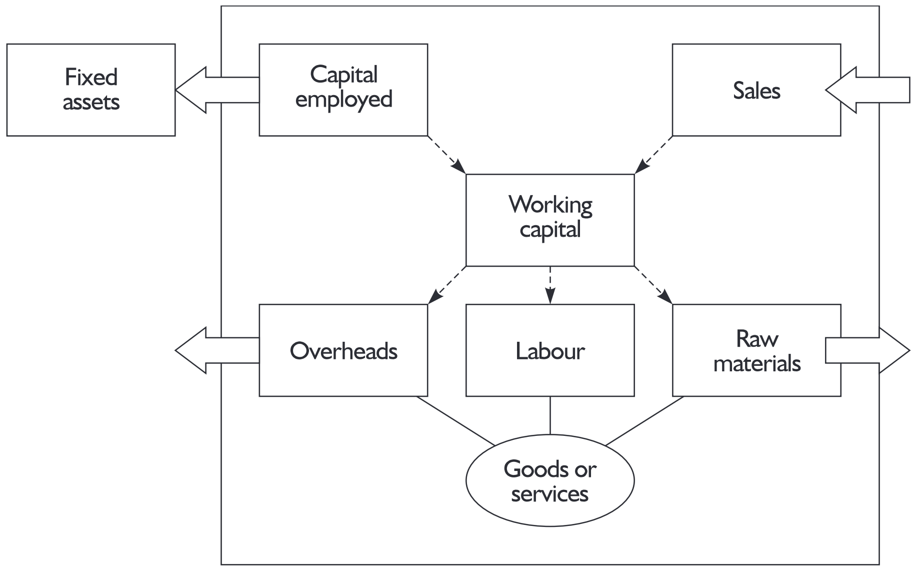
All the items are used up within a year and so are current. George and Mary own the food and the cash in the till so these are current assets.

The amounts owed by the business to the supplier and the wages of a waitress are current liabilities.

Let's have a look at another couple of accounting terms you will meet regularly.

- People are often described as any organization's greatest asset. The accounting term for the cost of employing people is **labour**.
- When it is dark and cold you switch on lights and heating. In your business, you would also need to write letters to customers, send out invoices and so on. The costs of electricity, heating and items such as paper and stationery are called **overheads**. If you pay rent to a landlord then the rent is also an overhead.

So the picture of working capital can now be viewed as illustrated in 'Capital and working capital'. The large arrows indicate money flowing into and out of the business. The dotted lines indicate money flowing within the business.



Capital and working capital

Activity 15

10 mins

In George and Mary's cafe, they would expect to be paid in cash. But Saddiq sells electrical equipment, which is assembled in his factory, to a car manufacturer and sends out an invoice.

What problem might this cause for Saddiq's business?

A delay between the delivery of goods and receipt of payment can cause businesses difficulties and make it difficult for them to pay their bills on time. This problem can put small, and even large, organizations out of business.

It is normal for there to be a delay – a period of credit – between receipt of goods and payment for them. At any one time Saddiq's business will usually be owed money. People who owe money to the business are called its **debtors**. (You may also see these called **accounts receivable**, particularly if you use computer software written outside the UK.)

In turn, the business will owe money to its **creditors**. (These are called **accounts payable** in many places outside the UK.)

EXTENSION 1
If you would like to learn more about computerized accounts, the combination of book and exercise disk listed on page 92 provides a useful introduction.

Remember the difference between debtors and creditors. They are easy to confuse, but:

- debtors owe money to the business;
- the business owes money to creditors.

3 Cash flow

To stay in business and make a profit an organization must make sure that cash is available in the right quantity and at the right time to meet its commitments. To understand why this is so important you must get to grips with the fact that profit and cash are different.

When an item is sold for more than it cost to produce the seller makes a profit at the time of the sale. But if the sale is on credit then the profit is not really felt by the seller – or **realized** – until the cash is received from the debtor. During that period of credit the seller may simply run out of cash, so employees can't be paid, debts pile up and the whole thing ends in tears. This explains why so many companies that are 'profitable' fail – they are also, unfortunately, broke.

A cash flow forecast is a statement which identifies expected cash receipts and payments in advance.

Without good control over cash there will be no future in which to try to make a profit. One technique that all businesses use to plan the money flowing in and out of the organization is a **cash flow forecast**. Once a forecast is made, it can then be compared with actual cash receipts and payments, week by week or month by month.

Let's look at an example. The Sharp Bakery has made a cash flow forecast of money coming in and going out of its business. Here is an extract:

Cash flow forecast – weeks 1 to 3

	Week 1 £'000	**Week 2 £'000**	**Week 3 £'000**	**Week 4 £'000**
Cash receipts (sales)				
Bread	150	150	150	
Cakes	250	250	250	
Total cash receipts	400	400	400	
Cash payment				
Ingredients	(106)	(106)	(106)	
Wages	(144)	(144)	(144)	
Overheads	(35)	(35)	(35)	
Van costs	(20)	(20)	(20)	
Total cash payment	(305)	(305)	(305)	
Net cash	95	95	95	
Cash balance B/F	Nil	95	190	
Cash balance C/F	95	190	285	

This statement is a forecast of the flows of cash in the first three weeks of trading of the bakery. Each expected item of cash receipts income is listed and, in this case, this is derived entirely from sales of bread and cakes. Then each expected item of cash payment expenditure is listed. In this case the costs are of making and delivering the bread and cakes.

The difference between receipts (cash in) and payments (cash out) is the forecast cash flow or **balance** or net cash at the end of each week's business. So, to take the first week, £305,000 of cash payments are deducted from £400,000 of cash receipts to give a cash balance of £95,000.

'Balance B/F' means the cash balance brought forward from the previous week and 'Balance C/F' means the cash balance carried forward to the next week. As Week 1 was the first week of business, no cash was brought forward.

Check your understanding of this cash flow statement by completing the next activity.

Activity 16

10 mins

a Looking at the cash flow forecast above, what is the value of the forecast weekly cash sales?

b What is the forecast weekly wage bill?

c What are forecast weekly total cash costs?

d Assuming the figures for cash receipts and payment don't change from week to week, what is the net cash receipt for Week 4?

e Calculate the balance to be carried forward from Week 4 to Week 5.

The correct figures are:

a £400,000

b £144,000

c £305,000

d £95,000

e £380,000

We can see the business is forecasting a regular pattern of cash receipts and payments. In a more complicated situation, a business will have to plan for fluctuating receipts and payments.

This forecast can now be used to compare with actual recipts and payments. After the first week's trading, the actual receipts and payments are entered:

	Week 1 Forecast £'000	Week 1 Actual £'000	Week 2 Forecast £'000	Week 2 Actual £'000	Week 3 Forecast £'000	Week 3 Actual £'000	Week 4 Forecast £'000	Week 4 Actual £'000
Receipts								
Bread	150	140	150		150		150	
Cakes	250	220	250		250		250	
Total receipts	400	360	400		400		400	
Payments								
Ingredients	(106)	(112)	(106)		(106)		(106)	
Wages	(144)	(144)	(144)		(144)		(144)	
Overheads	(35)	(35)	(35)		(35)		(35)	
Van costs	(20)	(22)	(20)		(20)		(20)	
Total payments	(305)	(313)	(305)		(305)		(305)	
Net cash	95		95		95		95	
Cash balance B/F	Nil		95		190		285	
Cash balance C/F	95		190		285		380	

Activity 17

5 mins

In the table above, what is the actual cash balance at the end of Week 1?

Write this figure into the cash flow forecast. The actual balance brought forward is nil, so what is the actual balance carried forward to Week 2?

The correct figures are £47,000 at the end of Week 1 and, of course, this is the actual balance carried forward to Week 2. The closing balance of one period is the opening balance of the next.

The amount is calculated by deducting £313,000 from £360,000.

Activity 18

5 mins

The second week's actual trading figures for the Sharp Bakery are as follows:

		£'000
Receipts	Bread	150
	Cakes	200
Payments	Ingredients	105
	Wages	144
	Overheads	38
	Van	20

Add these figures to the table opposite and complete the calculation to find out the cash position at the end of week 2, writing it down below.

The cash balance at the end of Week 2 and carried forward for Week 3 is £90,000.

The comparison of actual figures with forecast ones gives management useful information on which to make decisions.

You can check the cash balance at the end of Week 2 in the table below.

At that stage you can see that the forecast cash balance was £190,000 and the actual position is £100,000 worse than that. You can see that sales have not been as high as expected although the expenditure is not vastly different.

	Week 1		Week 2		Week 3		Week 4	
	Forecast £'000	Actual £'000	Forecast £'000	Actual £'000	Forecast £'000	Actual £'000	Forecast £'000	Actual £'000
Recipts								
Bread	150	140	150	150	150		150	
Cakes	250	220	250	200	250		250	
Total receipts	400	360	400	350	400		400	
Payments								
Ingredients	(106)	(112)	(106)	(105)	(106)		(106)	
Wages	(144)	(144)	(144)	(144)	(144)		(144)	
Overheads	(35)	(35)	(35)	(38)	(35)		(35)	
Van costs	(20)	(22)	(20)	(20)	(20)		(20)	
Total payments	(305)	(313)	(305)	(307)	(305)		(305)	
Net cash	95	47	95	43	95		95	
Cash balance B/F	Nil	Nil	95	47	190		285	
Cash balance C/F	95	47	190	90	285		380	

Now let us take this one step further into weeks 3 and 4.

In Week 3, there is a Bank Holiday. Unfortunately, the bakery had not forecast any change in receipts because of this. During the same week a van crashed and had to be replaced, and an oven also developed a fault. The actual figures for Week 3 were therefore:

Receipts (sales)	Bread	£130,000	
	Cakes	£90,000	
Payments	Ingredients	£106,000	(normal orders for ingredients)
	Wages	£144,000	(Bank Holiday is paid for)
	Overheads	£44,000	(including oven repair)
	Van	£35,000	(including van purchase)

Activity 19

10 mins

Enter the figures for Week 3 into the cash flow forecast on page 29.

What is the actual cash balance carried forward at the end of Week 3? What does this tell you?

You should have found that the actual cash balance at the end of Week 3 is negative. Receipt of £220,000 less payment of £329,000 gives an outflow of £109,000 cash for the week. And deducting the £109,000 outflow from the opening balance of £90,000 results in a negative balance of £19,000. Therefore, you can see that the amount recorded as the actual balance carried forward for Week 3 in the cash flow forecast below is (£19,000).

This means that the bakery would need to borrow money to cover the excess of payments over receipts or, perhaps, defer payment of some expenditure.

We have also entered figures for Week 4 below. This was a good week:

	Week 1		Week 2		Week 3		Week 4	
	Forecast £'000	Actual £'000	Forecast £'000	Actual £'000	Forecast £'000	Actual £'000	Forecast £'000	Actual £'000
Receipts (sales)								
Bread	150	140	150	150	150	130	150	150
Cakes	250	220	250	200	250	90	250	250
Total receipts	400	360	400	350	400	220	400	400
Payments								
Ingredients	(106)	(112)	(106)	(105)	(106)	(106)	(106)	(100)
Wages	(144)	(144)	(144)	(144)	(144)	(144)	(144)	(144)
Overheads	(35)	(35)	(35)	(38)	(35)	(44)	(35)	(35)
Van costs	(20)	(22)	(20)	(20)	(20)	(35)	(20)	(22)
Total payment	(305)	(313)	(305)	(307)	(305)	(329)	(305)	(301)
Net cash	95	47	95	43	95	(109)	95	99
Cash balance B/F	Nil	Nil	95	47	190	90	285	(19)
Cash balance C/F	95	47	190	90	285	(19)	380	80

Activity 20

5 mins

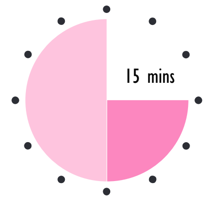
Now that you have been able to compare actual figures against the forecast ones for the first few weeks, what action, if any, might you consider taking if you were the owner of the bakery?

EXTENSION 2
Cash flow forecasts are looked at in greater depth in *The Business Plan Workbook*, including their part in a business plan.

The bakery has seen that the actual cash flow does not always coincide with its forecasts. As you may agree, the bakery should take note of this, learn to plan a little better, and be careful to keep costs down, especially as they appear to be producing a lot of waste product by producing the same amount of bread and cakes whatever the sales receipts.

In particular, the bakery should remember that sales will be limited in short weeks and should aim not to be over-ambitious in its forecasts.

Activity 21



S/NVQs B1.1, D1.1, D1.2

This activity may provide the basis of appropriate evidence for your S/NVQ portfolio. If you are intending to take this course of action, it might be better to write your answers on separate sheets of paper.

Take a look at any cash flow forecast available for your organization or, if that is not possible, you might like to draw one up for a club or society in which you are involved, or even for yourself and your family. Examine the actual results over time against the forecast and prepare a report covering:

- the success of the forecasting, as compared with actual results;
- the reasons why there were differences in the actual figures from the forecast (you may need to talk to your manager and others to find out the reasons);
- what can be learnt from any differences between the forecasting and its results.

Make any recommendations for future cash flow forecasting.

A cash flow forecast is a useful piece of information for management and the above activity will help you appreciate how resources are managed day to day. You may have covered a period where actual results were similar to the cash flow forecast, or discovered that external events can upset plans. You may be faced, as a first line manager, with the need to implement reductions and other changes in operations. Management may have made decisions requiring these actions based on its cash flow forecasting.