Week 5 Topic: Organizational Financial Practices

- Introduction
- Need of Capital
- Sources of Funds
- Budgeting and Monitoring
- Working Capital & Cash Flow

Introduction

- However good the quality of its products or services, no organization can be successful for any length of time unless its finances are soundly managed.

- Many young software engineers are attracted by the idea of starting their own company.

Need of Capital

- A group of new or recent graduates in computing decide to set up their own company to provide software services and their intention is typically to offer contract hire services
- A client is unlikely to pay an invoice within less than one month of receiving it. Some large companies are notorious for not paying invoices for as much as six or even twelve months.
- There will be a need to have some money with which to start the venture.

Need of Capital (continued)

- The group needs enough cash in hand to be able to live for at least three months. Additional money will be needed for the expenses of starting the company
- For large projects or packages, a much larger sum of money is likely to be needed while they are being developed because there will be no revenue coming into the company.

Need of Capital (continued)

- For starting period cash will be needed for:
  - Salaries
  - rent rates, heating and lighting of the premises used
  - equipment and consumables
  - costs of advertising and marketing the products
  - miscellaneous expenses, ranging from company stationery to travelling expenses

Need of Capital (continued)

- How does one set about raising this money? The first step is to produce a ***business plan***.
- It typically contains:
  - a description of what the company will be doing, together with information to show that it is technically feasible and that founders of the company have the necessary expertise
  - an assessment of the size of the market and the competition
  - a prediction of the financial performance of the company

Sources of funds

- They can be grouped into:
  - Grants
  - Loans
  - Sale of Equity

Grants

- A *grant* is a sum of money given to the company; while the company is obliged to demonstrate that it has been used for the purposes for which it was intended, it is not intended that the grant should ever be paid back to the organization which gave it
- The availability of grants and other help for new companies depends very much on where the company is located, how many people it expects to employ, and on government policy at the time.

Loans

- A loan is a sum of money lent to the company; interest is payable on it, at a rate that may be fixed or variable, and the loan is usually for a fixed period
- The company is liable to pay back the loan and, if the company goes into liquidation, the lender is entitled to recover the loan from the sale of the assets of the company.
- In most cases, security is required for the loan

Sale of Equity

- *Equity capital* is money paid to the company in exchange for a share in the ownership of the company
- Shareholders are at a much greater risk of getting a poor return on their capital or even losing it completely than are lenders but, in compensation for this, they stand to make a greater profit than lenders if all goes well

Budgeting & Monitoring

- A budget is a prediction of the future financial position of an organization covering , usually, the current or the next financial year
- The ordinary manager in a company is, however, much more concerned with budgeting for income and expenditure
- Budgeting is an iterative process

Budgeting & Monitoring

- The first version of the budget is likely to show expenditure exceeding income, since the operating managers will want to expand their operations while the sales and marketing department will not wish to give hostages to fortune by being over-optimistic about the volume of sales it can generate. Adjustments will have to be made repeatedly until a situation is reached in which budgeted sales exceed budgeted expenditure with a reasonable profit margin; the operational managers are happy that they can service the predicted volume of sales with the budgeted staff levels; and the salesmen are confident that they can produce the predicted sales

Working Capital & Cash Flow

- It is perfectly possible for a company to be consistently profitable and yet be unable to pay its bills
- Accounting normally operates on an *accrual* basis
- The value of *work in progress*
- It is usual to negotiate stage payments rather than leaving all payment until the work is completed.

Working Capital & Cash Flow (continued)

- Cash has therefore to be found to cover the gap between what a company has to pay out in cash and what it receives in cash—working capital
- A document "cash flow prediction" is the amount of cash expected to be received and disbursed in each of the next twelve months
- The bank specifies the maximum that can be borrowed on an overdraft but interest is only payable on the amount actually owed