

## 1

## Using budgets

What you need to know:

- the benefits and drawbacks of using budgets
- how to calculate and interpret variances
- how to use variances to inform decision making

### 1.1 The benefits and drawbacks of using budgets

The detail and the content of the budget should be the result of negotiation with all concerned. Those responsible for keeping to a budget should play a part in setting it, if it is to work as an effective motivator.

#### Benefits of budgets

Using budgets offers several benefits:

- Targets can be set for each section, allowing management to identify the extent to which each section contributes to the overall objectives of the business.
- Attention is drawn to inefficiency and waste, so that appropriate remedial action can be taken.
- Budgets make managers think about the financial implications of their actions and focus decision making on the achievement of targets and corporate objectives.
- Budgeting should improve financial control, if only because employees are aware that their actions are being scrutinised.
- Budgets can help improve internal communication.
- Delegated or devolved budgets can be used as a motivator by giving employees authority and the opportunity to fulfil some of their higher-level needs, as identified by Maslow (see pages 65–66). At the same time, senior managers can retain control of the business by monitoring budgets.

#### Drawbacks of budgets

The use of budgets can lead to the following disadvantages:

- The operation of budgets can become inflexible. For example, sales may be lost if the marketing budget is strictly adhered to at a time when competitors are undertaking major promotional campaigns.
- Budgets have to be reasonably accurate to have any meaning. Wide differences (or variances) between budgeted and actual figures can demotivate staff and call the whole process into question.

### 1.2 How to calculate and interpret variances

**Variance analysis** is the study by managers of the differences between planned activities in the form of budgets and the actual results that were achieved. Table 4.1 is an example of a monthly budget for a restaurant.

As the period covered by the budget unfolds, actual results can be compared with the budgeted figures and variances examined.

A **positive (or favourable) variance** occurs when costs are lower than forecast or profit or revenues higher, as in the case of sales revenue and profits in Table 4.1.

A **negative (or adverse) variance** arises when costs are higher than expected or revenues are less than anticipated. Examples are wage costs and food and drink in Table 4.1.

Item	Budget figure (£)	Actual figure (£)	Variance (£)
Sales revenue	39,500	42,420	2,920 (favourable)
Fixed costs	9,500	9,500	0
Wages costs	10,450	11,005	555 (adverse)
Food and drink	8,475	9,826	1,351 (adverse)
Other costs	5,300	6,000	700 (adverse)
Total costs	33,725	36,331	2,606 (adverse)
Profit/loss	5,775	6,089	314 (favourable)

Table 4.1 An example of calculating variances

### 1.3 How to use variances to inform decision making

Positive variances might occur because of good budgetary control or by accident: for example, due to rising market prices.

Possible responses to positive variances are:

- to increase production if prices are rising, giving increased profit margins
- to reduce prices if costs are below expectation and the business aims to increase its sales and market share
- to increase investment into the business or pay shareholders increased dividends if profits exceed expectations

Negative variances might occur due to inadequate control or factors outside the firm's control, such as rising raw material costs.

Possible responses to negative variances are:

- to reduce costs (e.g. by buying less expensive materials) to help to control costs
- to increase advertising in order to increase sales of the product and revenues
- to reduce prices to increase sales (relies on demand being price elastic)

The key issue about using the results of variance analysis to help decision making is to take into account the causes of the adverse or favourable variances. Just because a result is favourable does not mean that everything is in order. Neither does an adverse variance mean that the area responsible has been inefficient. A favourable production material variance could be generated from using lower-quality raw materials, which in turn could manifest itself as a drop in sales. Similarly, an adverse cost variance may occur because sales are higher than forecast and the business has incurred extra costs in supplying customers' demands.

#### Examiner's tip

Look for the relationships between revenues, costs and profits when considering variances. For example, if sales revenue has recorded a negative variance, it would be reasonable to expect costs, especially variable costs, to show a positive variance. If they do not, profits are likely to have a negative variance.

## 2

## Improving cash flow

What you need to know:

- the causes of cash-flow problems
- the methods of improving cash flow

### 2.1 The causes of cash-flow problems

Cash-flow problems can have a number of causes:

- **Poor management of cash flow.** If managers do not forecast and monitor the business's cash flow, problems are more likely to arise and more likely to lead to a serious financial situation. Similarly, the failure to chase up customers who owe the company money can lead to lower inflows and possible cash shortages.
- **Giving too much trade credit.** When a firm offers trade credit, it gives its customers time to settle their accounts — this might be 30, 60 or 90 days. In effect, this is an interest-free loan and while it helps to attract customers it slows down the business's cash inflows, thereby reducing its cash balance.
- **Overtrading.** This happens when a business expands rapidly without planning how to finance the expansion. An expanding business has to pay for materials and labour in advance of receiving the cash inflow from sales. A growing business does this on an increasing scale and may struggle to fund its expenditure.
- **Unexpected expenditure.** A business may incur unexpected costs, resulting in a cash outflow. The breakdown of a machine or a substantial rise in wages can lead to significant outflows of cash, weakening the enterprise's cash position.

### 2.2 The methods of improving cash flow

There are several methods of improving cash flow.

#### Factoring

This is particularly useful for small businesses, which may experience difficulty in controlling credit. Factoring enables a business to sell its outstanding debtors to a specialist debt collector called a **factor**. The business receives approximately 80% of the value of the debt immediately. The factor then receives payment of the bill from the customer and passes on the balance to the firm, holding back about 5% to cover expenses. This enables the business to improve cash flow considerably, as it does not have to wait for payment. Factoring does, however, reduce profit margins, as approximately 5% of revenue is 'lost'.

#### Sale and leaseback

This is a distinctive form of finance whereby the owner of an asset sells it and then leases it back. It provides a short-term boost to the business's finances, as the sale of the asset generates revenue. However, the business commits itself to paying rent for the asset for the foreseeable future.

#### Improved working capital control

This can help cash-flow management by:

- enabling lower stocks to be held, thus making more liquid assets available
- improving debtor control, ensuring that debtors do not overextend their credit terms, or allowing shorter credit periods (but this could have an impact on sales)
- lengthening supplier credit terms to allow finances to remain under the company's control for longer

Other possibilities are:

- stimulating sales, by offering discounts for cash and prompt payment
- selling off excess material stocks
- taking on additional long-term loans to improve the short-term cash position

### 3 Measuring and increasing profit

What you need to know:

- how to calculate and understand profit margins
- how to calculate and understand return on capital
- the methods of improving profits and profitability
- the distinction between cash flow and profit

#### 3.1 How to calculate and understand profit margins

Profit is a major objective for many businesses, but not for all businesses. Social enterprises, for example, pursue other targets such as helping the disadvantaged in society. It is simplistic to say that a business that makes a larger profit than another business is achieving a higher level of performance. It may be that the business generating the higher profits is much larger. To make a profit figure more meaningful, it needs to be compared to something else.

The **net profit margin** is a ratio that calculates the business's profit after the deduction of all costs as a percentage of its revenue from sales.

$$\text{net profit margin} = \frac{\text{net profit}}{\text{sales revenue}} \times 100$$

A business can calculate a profit margin for a single product or for all of its production. Table 4.2 shows examples of both of these methods of calculation.

Units sold	Sales revenue (£)	Total costs (£)	Profit (£)	Net profit margin (%)
24,500	232,750	200,165	32,585	14.0
1	9.50	8.17	1.33	14.0

Table 4.2 Net profit margin for a single product or for a business's entire output

Higher profit margins are better than lower ones. A higher profit margin gives a business a greater level of overall profit and allows it to reward its owners more fully or to invest in improving its scale or efficiency.

#### Examiner's tip

Always show your workings when calculating a profit margin. In the event of making an arithmetical error, you will still receive some of the marks available. If an examination paper includes a firm's profit margin, do not ignore it. Try to use it to develop an argument in answer to one of the questions.

Profit margins vary according to the type of business. Food retailers seek to sell food quickly and will accept a relatively low profit margin (Tesco's is around 6%) because they sell a large volume of products. In contrast, other retailers that sell more expensive

products less frequently might seek a much higher profit margin. Thus, a jeweller would expect a much higher profit margin than Tesco.

### 3.2 How to calculate and understand return on capital

Profits are the result of an investment by the owners of a business. One means of judging the profitability of a business is to compare the amount of profit to the investment that was needed to start the enterprise or project.

The formula to calculate return on capital is:

$$\text{return on capital} = \frac{\text{net profit}}{\text{capital investment}} \times 100$$

Assume an entrepreneur sets up a business by investing £250,000, and in a given year the business generates a net profit of £12,500. The return on capital in these circumstances would be  $\text{£}12,500/\text{£}250,000 \times 100 = 5\%$ .

Once again a higher figure is preferable. However, it is advisable to look at the return over a number of years. In particular, a newly established business will take time to build up a customer base and it is likely that its return on capital will improve over time. It is often true that businesses with high returns on capital are also risky. It is wise to judge the return on capital against the degree of risk. Finally, do take opportunity cost into account. In what other ways could this capital have been invested? A safer use with a slightly lower return might be a wiser use of the capital.

### 3.3 The methods of improving profits and profitability

Profits are simply a figure that measures the amount by which a business's sales revenue exceeds its total costs. Profitability measures profits against some yardstick, such as the sales revenue achieved by the business.

Firms can increase their profits by taking a variety of actions:

- **Increasing prices.** An increase in price has the potential to increase revenue without raising total costs. However, this is a risky strategy because an increase in price may result in a large fall in sales. In this situation, the result may be a decrease in profits if the fall in sales more than offsets the increase in price per unit. The extent to which this happens depends upon price elasticity of demand (see pages 92–93 for more details on price elasticity).
- **Cutting costs.** Lowering costs of production can increase the profit margin, as it should result in a higher profit margin. But this may be at the expense of quality. A decline in quality could have an adverse effect on the quantity of sales as well as the firm's reputation.
- **Using its capacity as fully as possible.** If a business has productive capacity that is not being utilised, its profits will be lower than they might otherwise be. If train companies run services that are only 50% occupied, their revenue is much lower. Offering deals and incentives to customers to use the trains could increase profits significantly, as it costs little more to run a full train than a half-full one.
- **Increasing efficiency.** Avoiding waste in the form of poor quality and unsaleable products, using staff as fully as possible and using a minimal amount of resources to make products are all ways of improving the efficiency of a business. Improving efficiency is likely to result in increased profits.

### 3.4 The distinction between cash flow and profit

It is important to understand that cash flow and profit are very different concepts.

Profit, at its simplest, is the surplus of revenues over total costs, over some defined period of time. If a business earns revenues of £2 million during a financial year and incurs total costs of £1.5 million, it will generate profits of £0.5 million.

Cash flow relates to the timing of inflows and outflows of cash to and from a business. The profitable business referred to in the previous paragraph might experience cash-flow problems for a number of reasons. The two listed below are arguably the most important:

- **If its customers are slow to pay.** This delays its cash inflows and may lead to it having difficulty in settling its own bills as they fall due. This can become a major concern if the business does not chase up its customers and require them to pay.
- **If it offers long periods of trade credit.** Giving customers 30 or 60 days to settle their accounts may help to increase sales but can result in a shortage of cash when it is needed.

Thus profitable businesses can face cash-flow difficulties if they do not manage their cash effectively.