5 Decision making to improve financial performance

1 Seasonal firms only see revenue (incoming cash) at particular times of the year. At other times of the year, they are not making income.

2 Construction companies often buy lots of their materials upfront (during the building phase) but will not receive any revenue until the end of the project when the construction is complete and they can sell the building. This may be many months later.

3 Gross profit is the difference between sales revenue and the direct costs of production.

Operating profit is the difference between gross profit and the indirect costs of production (expenses).

Profit for the year takes into consideration other expenditure, such as tax and interest payments, and other income, such as interest, to arrive at a final profit figure.

4 A profitable business may fail due to cash-flow problems. Although sales may have been generated to make a profit, not all money from these sales may have been received, causing cash-flow problems and, in the worst case, failure.

5 Focus on revenue may mean that the company loses sight of cutting its costs.

6 Reduction in the seasonality of sales; extension of credit period from suppliers.

7 return on investment = profit from investment/capital invested × 100

= 20,000/50,000 = 0.4 or 40%

8 A rise in interest rates is likely to both increase costs and reduce demand. Costs will rise due to higher interest payments on loans and demand will fall due to lower disposable income of consumers.

9 Takeaway food business are likely to employ minimum wage staff. Therefore, an increase in the minimum wage might lead to increased costs. Firms may have to adjust their cost objectives. Online food deliveries may lead to lower profit margins as the online food app may take a commission of sales.

10 A business might not be able to achieve financial targets in favourable market conditions due to a lack of resources. Limited factory space means that the firm is unlikely to grow and therefore it cannot increase its sales objectives beyond what it can produce at maximum capacity. Minimising waste, however, might lead to reduced costs.

11 Provides motivation and clear direction for staff; to control expenditure and reduce the outflow of money.

12 Looking at historical data from competitor firms; conducting market research on likely sales.

13 Revenues are lower than expected (e.g. there could be an economic shock); costs are higher than expected (e.g. raw materials and components may increase in price, labour costs may rise or the exchange rate may fall).

14 The firm can collect data over the years and use these historical data to inform future budgets. It is likely that variances will diminish over time.

15

Favourable variances	Response
Higher sales than expected.	Increase production.
Lower fixed costs.	Possibly reduce prices.
Reduced fuel costs.	Enjoy increased profits.
Reduced material costs.	Lower prices or enjoy higher profits.
Adverse variances	**Response**
Sales below forecast.	Increase advertising.
Wage costs higher than forecast.	Use more technology in production.
Material costs higher than forecast.	Seek new suppliers.
Profits below forecast.	Seek new markets.

16 Three benefits of budgeting are targets can be set and monitored for each part of the business; budgets may improve financial control by preventing overspending; budgets bring focus to decision making as a result of individual managers having to think about the financial implications of decisions.

17 Receipts; payments; running balance.

18 breakeven = fixed costs/contribution per unit

19 contribution = sales revenue – variable costs

sales revenue = 100,000 × £2.50 = £250,000

variable costs = 100,000 × £1.50 = £150,000

contribution total = £250,000 – £150,000 = £100,000

20 i breakeven = fixed costs/contribution per unit

fixed costs = £15,000

contribution per unit = 5 – 3 = 2

breakeven output = 15,000/2 = 7,500 units

ii profit = total revenue – total costs

total revenue = 10,000 × £5 = £50,000

total costs = £15,000 + (£10,000 × 3) = £45,000

profit = £50,000 – £45,000 = £5,000

21 i A rise in fixed costs will cause the breakeven output to increase.

ii An increase in price will lead to a fall in the breakeven output.

22 Breakeven analysis assumes that all output is sold and that it is all sold at the same price, neither of which are likely in practice.

23 Gross profit margin might be improving as a result of falling direct costs of production but, if the indirect costs are increasing at a higher rate, the operating profit margin could be falling.

24 Payables: money owed for goods and services that have been purchased on credit.

Receivables: money owed by a business's customers for goods or services purchased on credit.

25 A cash-flow forecast is important because it can be used in support of loan applications; it may identify periods when a business might be short of cash so corrective action can be taken; it may help in the planning for items of capital expenditure.

26 An overdraft is flexible as the business only pays interest on the amount that it borrows, but it is repayable on demand.

A bank loan is normally for a fixed amount and repayable over a period of time.

27 Kickstarter is a crowdfunding platform. It is a method of raising finance from a large number of people who each contribute a small amount of money. However, there is no equity sacrifice.

28

	Equity	Debt factoring
Advantage	+ Immediate cash. + No interest.	+ Immediate cash.
Disadvantage	+ Give up part ownership and control of the business.	+ Give up future income streams. + Expensive.

29

Cause	Solution
Poor management	Training or recruiting skilled managers.
Giving too much trade credit	Offer shorter periods or negotiate more favourable terms from suppliers.
Overtrading	Plan the financial aspects of growth thoroughly.
Unexpected expenditure	Have a contingency fund to meet such demands.

30 Increasing prices could lead to a fall in demand and revenue unless the product is price inelastic.

31 Costs might be reduced at the expense of quality, which might damage reputation.

32 It may lead to a loss of customers who prefer the previous (longer) credit period. The plumber is likely to have competitors who can offer better.

33 Dairy farmers only really sell to supermarkets, who have monopsony power. The supermarkets may refuse to buy produce from the high-cost farmers.

34 It may lead to a reduction in the quality of the product. For example, the school may have to cut some of its extra-curricular activities or increase its student–teacher ratio.