Year 11 Revision

Fixed cost	Costs that do not change with output- they have to be paid regardless of how much a business produces
Variable costs	Costs that do change with output- these costs are directly linked to the product or service
Start-up cost	Costs that a business has to pay when the business sets up. For examples, fixtures and fittings
Operating costs (running costs)	Costs that have to be paid for the day to day running of the business. For example, heat, light, rent etc…
Total costs	TC= FC + VC
Revenue	This is the money that comes into the business. It is also known as turnover or revenue
Profit	This is the amount of money that the business earns AFTER paying for all of its costs
Break-even	Level of output where **total revenue = total costs**
Margin of safety	This is the difference between your break-even point and the number of units you expect to sell
Cash flow forecasting	This is a forecast the business makes for what it expects to have coming into the business and out of the business
Inflows	Money coming into the business
Outflows	Money going out of the business
Cost of sales	Costs linked directly with the production of a product
Gross profit	GP= Sales- Cost of sales
Net profit	NP = Gross profit - expenditure
Income statement (profit and loss)	A statement of income and expenditure- usually produced every 12 months
Balance sheets (statement of financial position)	A statement outlining the financial position of the business
Assets	Things that the business owns
Liabilities	Things that the business owes
Sources of finance	Ways in which the business can raise money. These can be internal (from within the business) and external (outside of the business)
Budgeting	The process of planning income and expenditure within a business

Start-Up Costs These are costs which must be met before the business can start selling any products. They include, for example, buying premises (and any costs linked to this) and equipment, purchasing the initial stock and doing market research to find out if customers will buy the new product or service. Before a business starts trading it will need to spend money on equipment, possibly premises, and other large items it needs. If, for example, you were going to open a cafe, you would need to spend money on such things as:

- the premises
- a van
- tables and chairs
- an oven
- saucepans and plates
- knives and forks

Operating or Running Costs

These are the costs which, once the business is up and running, will have to be paid on a daily, weekly, monthly or annual basis. They include advertising the products; buying more stock; paying wages, rent, insurance, electricity; van repairs and petrol. Once the business is underway, it will have many regular bills to pay - these are called running costs or overheads. If we consider our cafe, it will have the following overheads:

- Advertising - using leaflets or maybe in a newspaper
- Supplies of food and drinks
- Washing-up liquid and cleaning materials
- Wages of the cook and waitress
- Rent for the premises
- Electricity
- Petrol, tax and insurance for the van

Costs of Different Types of Businesses

Depending on your type of business, your costs may differ. Types of businesses include:

- A retailer, like a corner shop, who simply buys things in and sells them for a profit.
- A business which sells services rather than goods. This means you pay for something to be done for you, rather than buying a product which you can carry away. Examples of service providers include a travel agent and a snooker club.
- A manufacturing business makes the goods which it sells rather than buying them in - an example would be a bakery or car manufacturer.

Category	A retailer	A supplier of a service	A manufacturer
Example of business	A clothes shop	A travel agent	An electrical goods manufacturer
Start Up Costs	Shop premises Changing cubicles Clothes rails Tills Chairs for customers Mirrors Van to fetch clothes Music equipment	Shop premises Display cases for travel brochures Computers Reception desks Telephone and fax	Factory unit Work benches Electric drills Screw drivers Lorry Cupboards for spare parts Research and development of new products
Running costs	Stocks of clothes Wages of shop assistant Advertising in newspapers Government tax and Insurance Van tax and insurance	Buying new travel brochures Wages of assistant Government tax and insurance Computer repairs Advertising in glossy magazines Training costs Uniforms	Stocks of metal components Power to run equipment Repairs of equipment Foreman's wages Machinists' wages Advertising in trade journals Petrol for and repairs to lorry

Direct Costs

If you are making a product, the materials and wage of the person making it will be called 'direct costs' because they are directly involved in making the product. Thus, the definition of direct cost is 'the costs directly involved in making a product'.

Indirect Costs

As well as paying for direct costs, the business will have many other bills to pay - costs of buying or running the premises/equipment/van, electricity, advertising, insurance, wages of people who are not actually making the products (cleaners, office staff, etc.). The definition of indirect cost is 'costs other than those involved in making the product'.

Fixed, Variable and Total Costs - Another way of categorising costs is by looking at whether or not they increase when you increase the number of products you make and sell.

Fixed costs

The definition of fixed costs is 'costs that remain the same regardless of how many items you make or sell'. An example would be your rent. If you pay £1,000 a week for rent, you will pay this whether you make one product, 10 products or even 100 products! The amount you pay remains the same even though what you make and sell goes up. In the long term your fixed costs would go up because, ultimately, you would have to rent more premises.

Variable Costs

You only have to pay variable costs if you produce something. An example would be materials. If you were making boxes and the wood cost you 50p for each box you made, the materials bill would be zero if you made no boxes. If you made 10 boxes, it would be £5. If you made 20 boxes, it would be £10 and so on - thus the definition of variable costs is 'costs that increase directly with changes in production or output'.

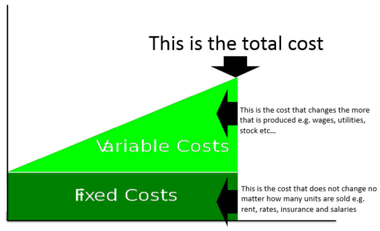
Remember:

- With a variable cost, if you produce zero units, the cost will be zero - which is why the line crosses the axes at zero units and zero costs.
- The more you produce, the more the cost increases - which is why the line goes up as the number of units increases.
- Other examples of costs like this are piecemeal machine operators' wages (where they get paid according to how many they produce); telephone (the more calls you make the more you pay); electricity; VAT (paid on the number of units).

Total Costs

This refers to the total costs of the business - which includes the fixed and the variable costs.
The formula definition is:

Total Costs = Fixed Costs + Variable Costs



Revenue

Businesses need to earn money to survive. We call the money they make 'revenue'. The main source of revenue is from the goods/services the business offers.

In order to work out the amount of money a business makes from selling goods and services we have to multiply the number of units sold by the selling price.

Number of Sales x Price Per Unit = Revenue

Other Sources of income
We have seen that businesses sell goods and services to earn revenue and bring in income. However, there are some other forms of revenue too (all with the word 'received' on the end):

- Rent received - one way to make extra money is to rent out part of your premises to another business.
- Interest received - this is where the business has money in the bank and receives money from the bank for not taking it out.
- Commission received - sometimes businesses help each other and sell each other's goods. If they sell a product for someone else, they may well earn an amount of money for doing this - a commission.
- Discount received - if a business buys from another, it is sometimes given a reduction in the purchase price. This is called a discount.

Expenditure

The term 'expenditure' means spending money. We have seen that this includes the capital expenditure needed to get the business up and running. It also includes paying for the overheads of the business (the running costs). Without this expenditure, the business would not be able to make a profit.

In order to work out the profit the business makes, it needs to deduct the overhead expenditure from its revenues (which we looked at previously).

Profit = Revenue - Overhead Expenditure

If the revenue is more than the expenditure, the business makes a profit.
If the expenditure is more than the profit, the business makes a loss.

Profit: revenue is more than expenditure
Loss: expenditure is more than revenue

<u>Break Even Point</u>

At the very least, a business will want to break even. This can be defined as 'making enough money through product sales to cover the cost of making the product (no profit or loss)'.

Break-even occurs when costs equal revenues.

Calculating Break Even point

A business may be considering selling a new product. It will want to know how many products it will need to sell to break even and cover its costs. This is useful information because, if it is unable to sell more than this, it is not worth selling the products.

The information we need to work out the break-even point is:

- the selling price of one unit
- the variable cost of one unit
- the fixed costs

Break even formula

- The formula to work out the break-even point is:

$$\text{Break-Even Point} = \frac{\text{Fixed Costs}}{\text{Selling Price Per Unit - Variable Cost Per Unit}}$$

<u>How to work Break even formula out:</u>

Contribution formula

The first thing I did was to work out the contribution:

Contribution = Selling Price - Variable Cost

Number of Units to Break Even

The next thing I did was to work out how many units I need to sell to pay off my fixed costs and break-even:

Number of Units to Break Even = Fixed Costs ÷ Contribution

<u>Financial Records</u>

A business keeps various types of financial record to monitor its performance and ensure that taxes are paid. These include cash flow statements, profit and loss accounts and a balance sheet.

Trading, profit and loss account otherwise known as Income Statement

A **trading, profit and loss account** shows the business's financial performance over a given time period, eg one year.

Sample trading, profit and loss account

Sales revenue	£80,000
Less costs of sales	£50,000
Gross profit	**£30,000**
Less other expenses	£20,000
Net profit	**£10,000**

The **trading account** shows the business has made a **gross profit** of £30,000 before taking into account other expenses such as overheads.

The **profit and loss account** shows a **net profit** of £10,000 has been made.

Balance sheet also known as Statement of Financial Position

A balance sheet shows the value of a business on a particular date. A balance sheet shows what the business owns and owes (its assets and its liabilities).

Assets

Fixed assets	£150,000
Current assets	£25,000
Current liabilities	£100,000
Net assets employed	**£75,000**
Capital and reserves	£75,000

Fixed assets show the current value of major purchases that help in the running of the business, like delivery vans or PCs. In this case £150,000 of fixed assets are owned. **Current assets** show the cash or near-cash available to the firm. This includes stock ready to sell, money owed to them by debtors and cash in the bank. There are £25,000 worth of current assets.

Deducting all the **current liabilities** from the total amount of fixed and current assets gives the value of the business on the day the balance sheet was drawn up. This business is worth £75,000, financed by £75,000 of share capital and reserves. Capital and reserves are in effect liabilities, because the firm owes this money to the owners. What a firm owns, it owes.

Working capital

A business is **solvent** if it can meet its short-term debts when they are due for payment. To do this it needs adequate **working capital**. There are three main reasons why a business needs adequate **working capital**. It must:

Wages paid to employees are part of a company's variable costs

- **Pay staff wages and salaries**.
- **Settle debts** and therefore avoid legal action by creditors.
- **Benefit from cash discounts** offered in return for prompt payment.

You can calculate a firm's working capital by using the following equation:

working capital = current assets - current liabilities

Many groups of people are interested in the published accounts of a company. The information they provide may influence future decisions. For example, lenders will be looking at the solvency of a business. Rivals are interested in monitoring the profits earned by competitors.

Advantages and disadvantages of Cash flow, Breakeven, Income Statements and Statements of Financial Position.

Learn these

Breakeven Analysis	
Advantages	**Disadvantages**
• Tables and diagrams that show break-even analysis are easy to view, comprehend and interpret. This makes it a valuable tool, as it does not take a long time to calculate or use. • Break-even analysis is a beneficial management tool to aid the decision making process. • It can be used to show the level of profit at a given level of output, and to set targets for achieving profits. • The margin of safety can be established. • A business can use break-even to consider the consequences of changes for a particular product.	• The overall problem with break-even as a decision making process tool is that it is based on using predicted figures. There is no certainty that costs and prices will be accurate or constant. • The direct or variable costs may change, depending upon the quantities involved. A new diagram/table may have to be have drawn, which is time-consuming. • As the level of production increases, the opportunities to gain the benefits of economies of scale with affect unit costs. • If there is more than one product involved, it may be difficult to allocate the fixed costs. Calculating the break-even may be difficult. • Calculating the total revenue relies on just one price. In business, this is unlikely as discounts or promotional offers may be used.
Evaluation	
Overall it is clear that breakeven analysis is limited to its uses because although it helps the decision-making process, it is based upon predicted figures. Therefore the extent to which breakeven analysis is useful depends upon the accuracy of the figures used.	

<table>
<tr><th colspan="2">Cash Flow Forecasts</th></tr>
<tr><th>Advantages</th><th>Disadvantages</th></tr>
<tr><td>Allows a business to see when they might need a loan or any other type of finance
Able to plan for any unexpected bills/payments they may have in the future
If positive, the business can use a cash flow forecast to obtain a bank loan</td><td>Only a rough estimate, not very accurate
Only accounts for a small portion of the year
May not take into account payments that will affect the business in the future</td></tr>
<tr><th colspan="2">Evaluation</th></tr>
<tr><td colspan="2">Cash flow forecasts are helpful to give the business a rough estimate of where they will be financially throughout the year. however, it may be a shock when an unexpected payment comes into play</td></tr>
</table>

Income Statements (Trading, profit and loss accounts)

The income statement is **a historical record of the trading of a business over a specific period** (normally one year). It shows the **profit or loss made by the business** – which is the **difference between the firm's total income and its total costs.**

The income statement serves several important purposes:

- Allows shareholders/owners to see how the business has performed and whether it has made an acceptable profit (return)
- Helps identify whether the profit earned by the business is sustainable ("profit quality")
- Enables comparison with other similar businesses (e.g. competitors) and the industry as a whole
- Allows providers of finance to see whether the business is able to generate sufficient profits to remain viable (in conjunction with the cash flow statement)
- Allows the directors of a company to satisfy their legal requirements to report on the financial record of the business

Advantages of income statements:

- Income statements show how a business performed financially over a year
- They can help managers to spot if the business is spending too much money and highlight areas where costs could be cut
- Businesses can use income statements to check they are making enough revenue, and use this information to adjust their prices
- Income statements can be compared (usually yearly) to monitor the business. This allows the business to manage its success and highlight any area where it could improve

Disadvantages or Problems faced if a business doesn't complete an income statement:

- A business won't know how much money it has made so it won't be aware of its financial position and won't be able to take action to improve it
- The business won't know how much net and gross profit it has made, so won't know it is successful or facing bankruptcy
- The business won't know if it is spending too much on business expenses or producing a product and it could risk making a loss
- It won't know if it generating enough revenue so it won't know whether it needs to adjust its prices
- It won't have any financial records to compare each year, so it won't be able to monitor the business's success over an extended time period

Balance sheet (otherwise known as Statement of Financial Position)

Advantages of balance sheets:

- They help a business know how much it's worth
- They show what a business owns
- They help a business know how much they owe to other people
- They show how a business is being funded and how it is using those funds
- They show a business if it is not using its resources effectively, e.g. a business might have excess stock or unused machinery
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Disadvantages or Problems faced if a business does not complete a balance sheet:

- A business won't know how much it is worth. So it won't know what it's financial position is
- It won't know what it owns so it might not use its resources effectively
- It won't know what it owes so it could fall behind with payments and risk bankruptcy
- It won't know how it's using its funds so it might not know if it needs to raise extra capital or arrange a loan or overdraft

Sources

http://www.bbc.co.uk/schools/gcsebitesize/business/finance/

http://www.bbc.co.uk/schools/gcsebitesize/business/finance/accountsvid.shtml