

1.3 - Putting a Business Idea Into Practice

Topic overview

In this topic students need to continue to relate the concepts to the contexts in which an enterprise and an entrepreneur will be operating. They must be aware how business implementation can be affected by the local and national business environment and how this might impact on a small business. Students must be aware of this sections relationship with the other areas in this theme and how again, this may impact on business decision-making.

Section	Key things to learn
Business aims and objectives	Defining business aims and business objectives Financial aims for a start-up business Non-financial aims for a start-up business Differences in business aims and objectives between firms
Business revenues, costs and profits	Understanding and calculating business revenue Understanding and calculating business costs Understanding and calculating business profit and loss Interest Break even concept and the margin of safety Interpreting break even diagrams Changes in break-even variables
Cash and cash-flow	The importance of cash in a business Cash versus profit Interpreting cash-flow forecasts
Sources of business finance	Short term finance options for small and start-up businesses Long-term finance options for small and start-up businesses

Business aims and objectives

What motivates someone to become an entrepreneur?

For many people this will be money. The chance to earn significant profits, buy a yacht, take numerous holidays, buy designer goods and send the kids to the best private schools.

Money and personal wealth may well however, not be the real motivation. Evidence suggests that there are many more reasons why someone wants to start a business.

Every business starts small. However, if the entrepreneur takes some calculated risks, shows a lot of determination and has some luck, a start-up business can become very large, profitable and valuable. However, not every entrepreneur wants to build a big business and earn a fortune.

The objectives when starting a business can be broadly split into two categories: **financial** objectives and **non-financial** objectives.

The purpose of business aims and objectives

Aims and objectives provide a direction for any business. Without clear objectives, a business may provide goods and services that are not appropriate to why the business was set up. This may result in the business not being successful. Having objectives just written down however, is not enough to ensure business success. In order for objectives to be effective, they must be implemented and monitored over time. Some of the benefits to a business of having clear objectives are as follows:

Reason	Explanation
Direction	Clear objectives will allow a business to decide on the direction it should take, for example, whether it should expand or not, whether it should change its target market or perhaps increase or decrease its range of goods or services.
Focus for employees	It is important that all employees are aware of the business's objectives and that they are attempting to follow and meet them. If all employees are working together in the same direction, this will increase efficiency.
Allows planning	The overall firm's strategy, what it plans to do in the future, will be in its business plan. Having clear objectives will allow consistent planning for the business as a whole and any departments within the business. The plan will be designed so that the business objectives can be met.
Measurement of success	Having business objectives allows a business to measure its success. In other words, through a business reviewing its objectives, it would be able to see if it had achieved them or not or whether it was on the way to achieving them. This means that the business can then correct or change its business strategy if it is not working. A business might also need to change its business objectives if they are proving impossible to meet or if they are being achieved too easily. The ability to measure success is much easier to carry out for financial objectives, which are easily quantifiable, rather than non-financial objectives, such as "being more ethical" or "increasing customer satisfaction", which are very difficult to measure.

Financial objectives

- **Survival** – over half of new businesses fail within five years and many new businesses do not survive much beyond their launch. Often entrepreneurs discover that their business idea was not as good as they originally thought and therefore the business cannot run profitably or it runs out of cash. Changes in the business environment also may make it harder for a business to be successful. The first priority of a business is therefore always to survive.
- **Profit** – making profit is the main objective for most businesses. This is the reward to the entrepreneur for their hard work and the **risks** undertaken, often with their own money. Ideally, the profit earned is sufficient to provide the entrepreneur with enough income to live on. Profits may also be kept in the business to allow it to expand or develop further. Other objectives businesses may have which are linked to profit maximisation are **increasing revenue**, the amount made from sales, or **decreasing costs**.
- Another financial objective is **financial security** or **personal wealth**. Working for someone else might mean the loss of a securely paid job, which means the entrepreneur would have no

financial security. Some entrepreneurs have a longer term objective. They aim to build a valuable business that can substantially increase their future wealth. They could be aiming to build up the business and sell it, or make it so it will provide a substantial future income for them, with no risk to them of being made redundant!

- **Sales maximisation/market share** – some businesses will be more concerned with increasing their sales and therefore their market share. They may accept lower profits in the short term, in order to increase sales.

Non-financial objectives

Although most businesses will be focussed on financial objectives, there are many other priorities that will exist for new and small businesses. Providing a high quality service will be particularly important for a new business. Looking after its customers and its employees would also be an objective for many small businesses.

In many cases, non-financial objectives will link to or be consistent with financial objectives, but not always as sometimes even for a small business quality might conflict with profit. Therefore when businesses set and use objectives, they will prioritise the areas which are most important to their organisation and the owners.

Here are some of the non-financial motives that are often quoted by entrepreneurs:

- **Social objectives** such as benefiting the environment
- **More control over working life** – want to choose what kind of work is done; the need for greater **independence** is a major motivator
- **A more flexible and convenient work schedule**, including being able to work from or close to home; this motive is an important reason behind the many home-based business start-ups
- **Skills are being wasted** and their potential is not being fulfilled
- **Escaping** an uninteresting job or career
- Pursuing an **interest or hobby** that they enjoy
- **Want to be the boss**, as they are fed up with being told what to do
- Want the feeling of **personal satisfaction** from building up a business
- **Fed up** with working in a business hierarchy or a bureaucratic organisation, where there are lots of rules; people with entrepreneurial characteristics often feel stifled working with and for others!
- **Major change in personal circumstances** for example redundancy, divorce, illness, bereavement

Different aims and objectives

Different businesses will have different aims and objectives. This is particularly the case with small businesses, where every entrepreneur is likely to have different motives for starting up their own business. For example:

Entrepreneur 1: has recently been made redundant from a large building firm. He would like to turn his skills and experience into building maintenance in his local area. He wants varied work and enough money to live off, but does not want to build up the business or travel far.

Entrepreneur 2: has a new business idea for a web application for finding places for a good night out. The idea is proving very popular in the local trials. The entrepreneur wants to develop this application and sell it all over the world in order to make a lot of profit.

Business objectives will also be affected by the external environment which firms operate within. A small low cost hairdresser may have direct competition in one area, indirect competition from an expensive hairdressing national brand in another area and no competition at all in a further area. The objectives of such a small business will be different because of the situation it finds itself in.

Business revenues, costs and profits

In order for a business to calculate its profit (or loss) it needs to work out its total costs and total revenue.

Costs are the spending that a business has to undertake in order to make goods and provide services. Every business has costs, but they vary in terms of their type and amount. For a new business, estimating what the likely costs are going to be is often very difficult.

Successful businesses place great importance on costs. In most cases they want to ensure they are kept as low as possible. There are many reasons for this including:

- Increases in costs reduce the possible profits that the business can make
- They are the **main cause of cash-flow problems** in a small business
- They will change as the output or activity of a business changes

Costs can be divided into two types: **fixed and variable**

Fixed costs

Fixed costs do not change as output varies. In other words, they are fixed even if output moves up or down from period to period.

Examples of fixed costs include:

- Rent and council tax
- Salaries
- Marketing, for example advertising, market research
- Insurance
- Interest repayments
- Leased equipment charges

It is worth remembering that just because a cost is classified as “fixed”, it does not mean that the cost will stay the same forever. A fixed cost can change over time. For example, the rent of an office or shop may stay the same for 5 years. However, the rent may change (up or down) when the rental agreement is renegotiated when due. The important point about a cost, like rent, being “fixed” is that it **has to be paid**, whatever the level of sales achieved.

Fixed costs are particularly important when it comes to calculating the **break even output** of a business. The higher the level of fixed costs in a business, the higher the output needed to cover these costs and break even.

Variable costs

Variable costs change when output changes. In other words the higher the output, the higher the variable costs.

Variable costs tend to be those relating directly to the production or sale of a product. Good examples include:

- Raw materials and bought-in stocks and components
- Wages based on hours worked or amount produced
- Marketing costs based on sales
- Agent and other commissions

Total variable costs can be calculated by a simple formula:

$$\text{Variable cost per unit} \times \text{output}$$

Total costs

The total costs of a business can be calculated by simply adding together the variable costs, at different levels of output, to the firm's fixed costs. The formula therefore is:

$$\text{Total costs (TC)} = \text{total fixed costs (TFC)} + \text{total variable costs (TVC)}$$

Example:

Graham's van repair business is a small business that has the following costs and sales output for March:

Variable costs per job	£75
Garage rent and rates	£500
Salaries	£1,500
Advertising	£100
Other fixed costs	£400
Expected number of jobs for month	100

To calculate the total costs for the business, start with the **variable costs**. These equal £75 per unit x 100 jobs = **£7,500**

Fixed costs = £500 (garage rent and rates) + £1,500 (salaries) + £100 (advertising) + £400 (other fixed costs) = **£2,500**

Therefore the **total costs** for Graham's business equal £7,500 (total variable costs) + £2,500 (total fixed costs) = **£10,000**

As output increases the total costs will not increase as fast. This is because the fixed costs will stay the same. This means that a business may have lower average costs of production as it grows.

Revenue and Profit

Revenue

Revenue is the money the business receives from its sales. This can be represented simply using the formula:

$$\text{Revenue} = \text{selling price per unit} \times \text{quantity sold}$$

In practice, most businesses sell more than one different product and have more than one selling price, which makes the calculation more complicated. However, the method remains the same.

In the above example, if Graham charges £100 for each job that he completes, his **revenue** will equal: £100 (selling price per unit) x 100 (quantity sold) = **£10,000**.

Is Graham's business making a profit?

Profit

Having calculated the total costs and the total revenue for a business, it can now work out its profit. Profit is the financial **return** or **reward** that the owners of a business aim to achieve to reward them for the **risk** that they take. It will measure the success of that investment.

Profit is also an important signal to other providers of finance to a business. Banks, suppliers and other lenders are more likely to provide finance to a business that can demonstrate that it makes a profit, or is likely to do so in the near future, and that it can pay debts as they fall due.

Profit is also an important **source of finance** for a business. Profits earned, which are kept in the business and are not distributed to the owners via dividends or other payments, are known as **retained profits**. Retained profits are an important source of finance for any business, but especially start-up or small businesses. The moment a product is sold for more than it cost to produce, then a profit is earned which can be reinvested

Profit can be measured and calculated by the following formula:

$$\text{PROFIT} = \text{TOTAL REVENUE} - \text{TOTAL COSTS}$$

Here is an example which illustrates the formula in action:

Sales	Costs	Profit or loss?
£100,000	£75,000	£25,000 profit
£100,000	£125,000	(£25,000) loss Note: negative figures are shown in brackets
☒ Total sales greater than total costs = PROFIT ☒ Total sales less than total costs = LOSS ☐ Total sales = total costs = BREAK EVEN		

Whatever the result, profit, loss or breaking even a business will always need to review its performance and look at how it might be improved. Can costs be decreased? How? And by when? Can revenue be increased? Should the price stay the same? Can more be sold? Is there a need for further investment to decrease costs or increase revenue?

Interest

As well as the costs involved in running a business, a business owner may also have to pay interest, if the business needed to borrow money in the form of a loan or mortgage when it was set up. The business may also arrange an overdraft with the bank, which will also involve the payment of interest. Interest will therefore form part of the firm's total costs. The amount needed to be paid may vary if interest rates change. This is however, dependent on the terms of the loan/mortgage/overdraft, which would have been agreed with the bank and the business owner, when the specific source of finance was first taken out.

The following formula can be used to calculate the interest rate on a loan as a percentage:

$$\text{Interest on loans (\%)} = \frac{\text{total repayment} - \text{borrowed amount}}{\text{borrowed amount}} \times 100$$

Example:

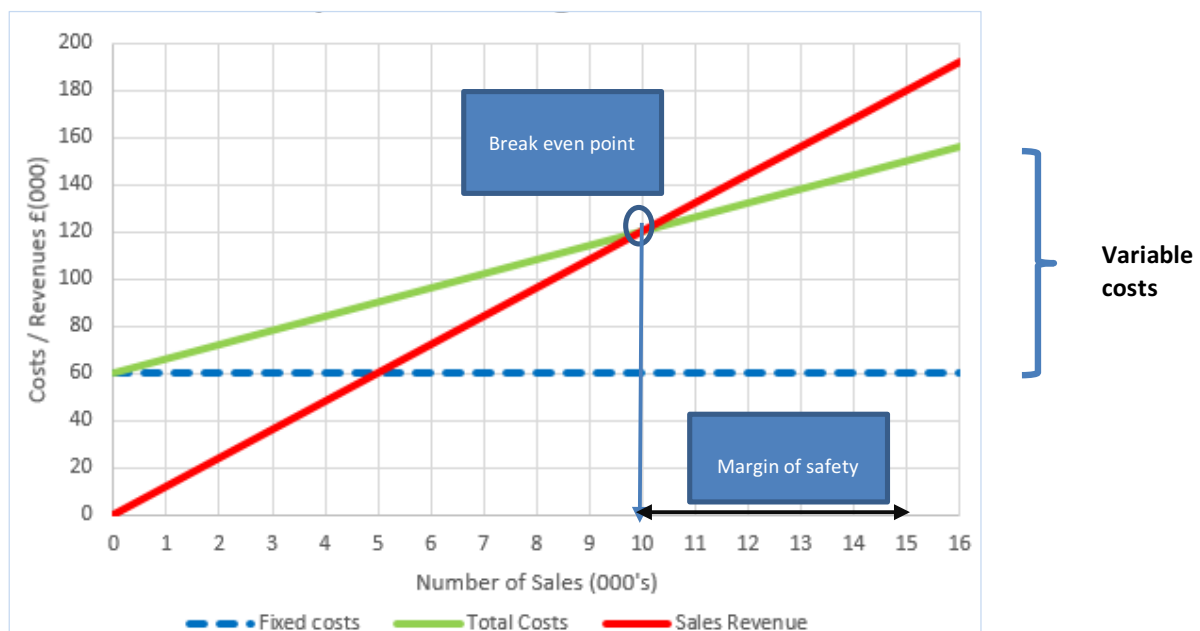
If a new business start-up borrowed £50,000 but repaid £60,000 in total, the interest percentage would be: $\frac{£60,000 - £50,000}{£50,000} \times 100 = 20\%$

Break even

A business will calculate its break-even point in order for it to have an idea of how much it will need to produce to survive. Break-even is the point where total revenue is equal to total costs, which means the business is not making a profit or a loss. Through calculating break even, a business knows how many units it will need to produce and sell in order to start making a profit.

This information can be represented on a break even diagram or graph and will show the potential profit or loss that could be made at different levels of output, as revenue and costs change.

Break even diagram for Business A:



This break even diagram shows that fixed costs are drawn as a straight line, which is the case because they do not change with output. The total cost line is also shown, instead of the variable cost line on its own, as the total cost line takes into account both fixed and variable costs. The total cost line starts at the same point as fixed costs, as even if the business is making no output, fixed costs still need to be paid. At zero output however, variable costs are zero resulting in fixed costs and total costs being the same value. The revenue line is lastly drawn, which starts at zero and goes up diagonally. This is because as the business makes and sells more, it will gain more revenue.

In this example, Business A's break-even point is 10,000 units, the point where total costs and total revenue cross. This means that if the business manages to produce and sell this amount of output, it will not be making a profit or a loss.

Margin of safety

Business A can also calculate the margin of safety from the break-even diagram. This is the difference between its current level of output/sales and the break-even point. If Business A was currently selling or producing 15,000 units, its margin of safety would be 15,000 (current level of output) – 10,000 (break-even point) = 5,000 units. Business A would want the margin of safety to be as high as possible, as this shows how much output or sales could fall before it hits its break-even point and then after this, the business would be making a loss.

A reminder of the formula for margin of safety is shown here:

$$\text{Margin of safety} = \text{actual or budgeted sales} - \text{break even sales}$$

Calculating profit and loss from the break-even chart

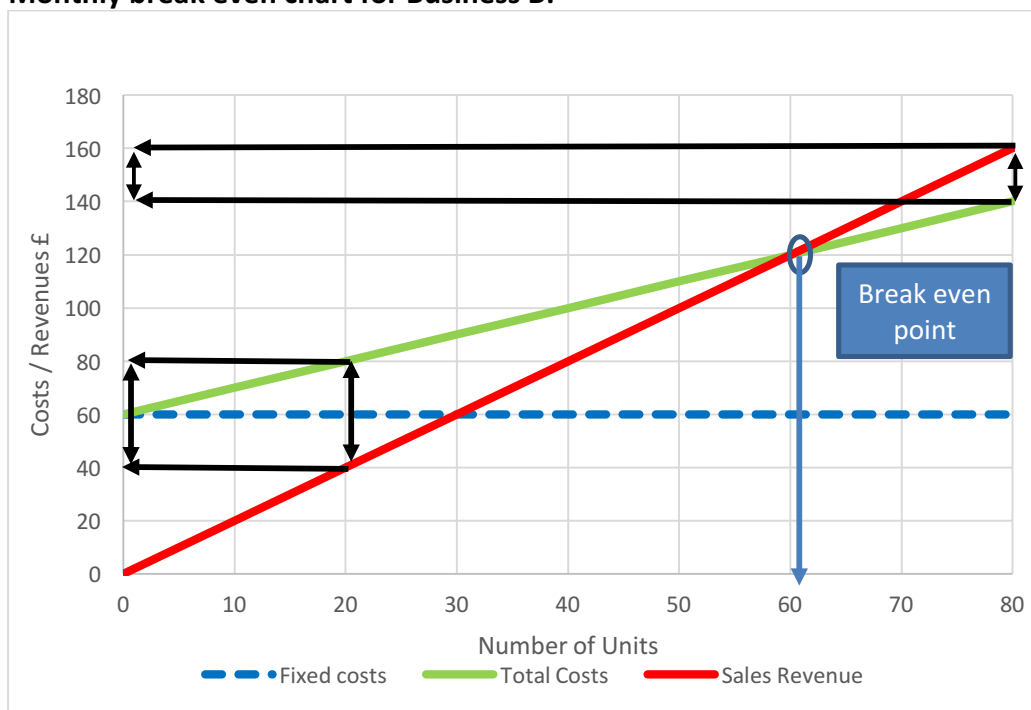
A business can determine the amount of predicted profit or loss level it expects to make at different levels of output from the break-even diagram. As already discussed, profit is calculated by deducting total costs from total revenue. From reviewing the break-even diagram for Business B (on the next page) it can be seen, at an output level of 80 units, the business is making £160 revenue and its total costs equate to £140. If we subtract the total costs from the total revenue the profit at this level of output equals: **£160 - £140 = £20**.

It is clear the business is making a profit at this level of output, as the firm's break-even point is 60 units (the point where total revenue = total costs) and as the business is operating at 80 units, a higher output level than the break-even point, then the business must be making a profit.

However, if the business is operating below the break-even point of 60 units, the business will be making a loss. Looking again at the break even chart for Business B and assuming the business is producing 20 units, the value of total costs at this level of output is £80 and the total revenue figure is £40. Remember that profit = total revenue – total costs, so in this case, the business is making a loss as: £40 - £80 = (£40).

This method of calculating profit/loss for a business can be applied to any level of output for a business that has produced a break even diagram. However, the difficulty is that sometimes values are difficult to read from the diagram and therefore if a business relied on this method only of calculating profit, inaccurate figures may be calculated and therefore used in decision making. For example, looking again at the break even chart for Business B, can the profit or loss be accurately worked out, purely from reading the graph, if the firm was operating at an output level of 55 units?

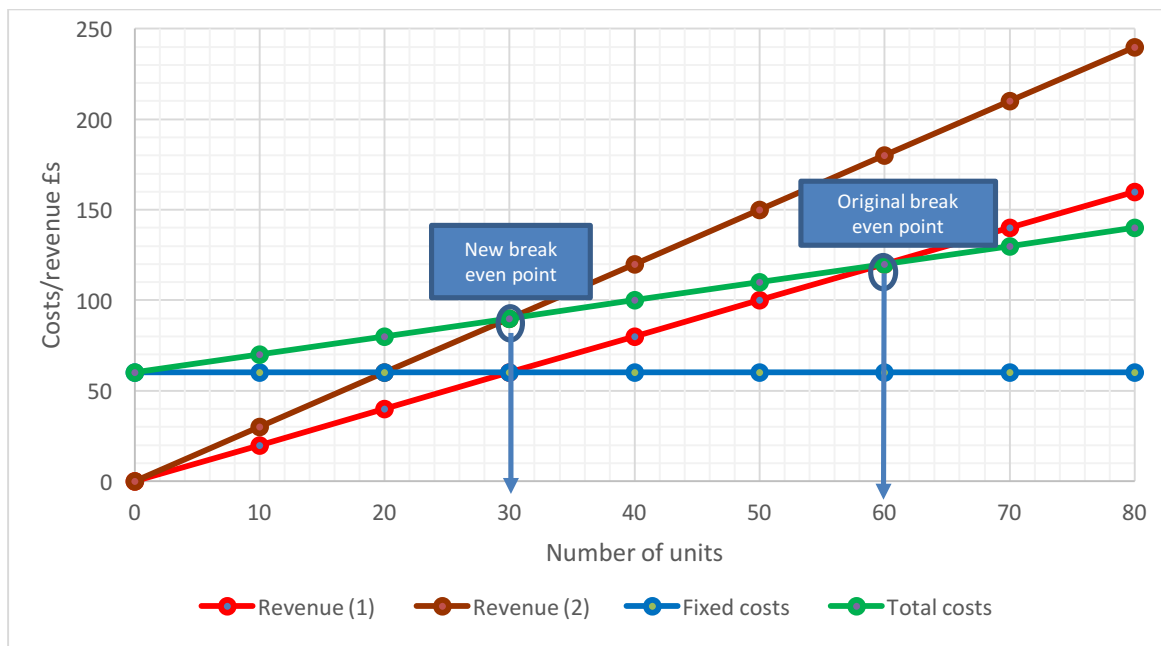
Monthly break even chart for Business B:



The impact of changes in revenue and costs on the break-even point

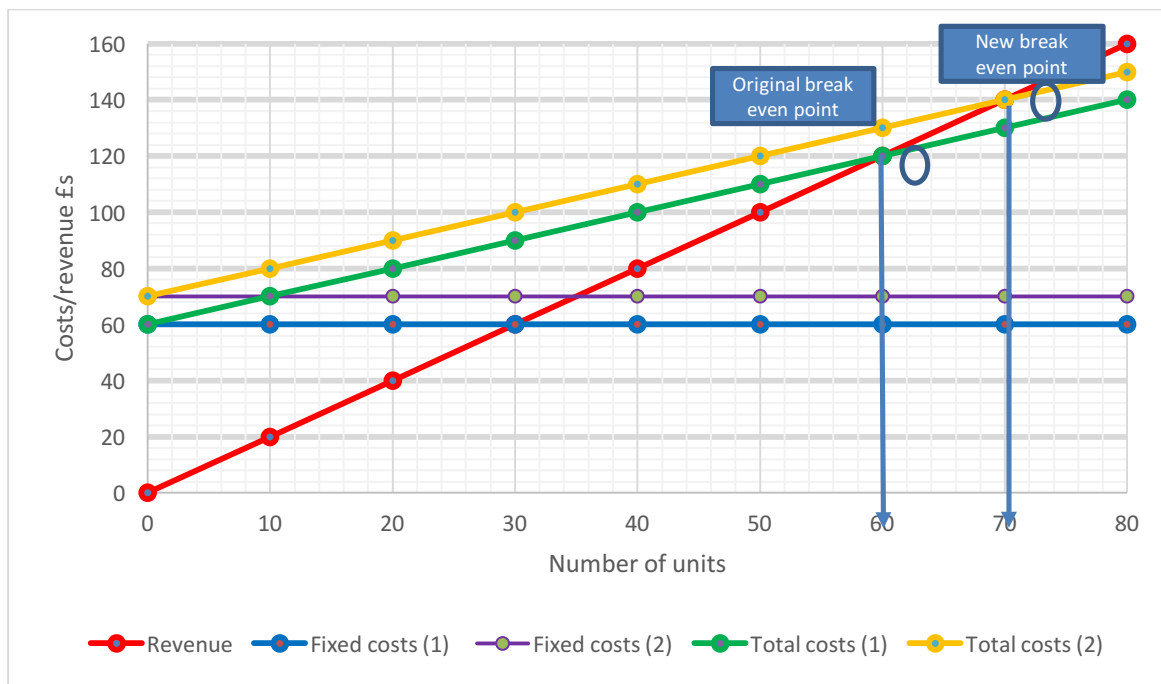
As well as calculating profit and loss and identifying the break-even point, the break-even diagram can also be used to help business owners with decision making and “what if” scenarios. By changing one or more variables in the break-even diagram, business owners, or business decision-makers, can then assess the impact of this change on the break-even point. This will allow worst and best case situations to be prepared for by the business. Some examples are included here to illustrate this further.

Example 1: Break even diagram to show the impact on the break-even point of an increase in selling price



In the above situation, a business's selling price has increased from £2 to £3. This has resulted in the amount needed to be sold to break even (the break-even output) decreasing from 60 units to 30 units. In this case, the business may then conduct some research to see if customers would be willing to pay the increased selling price or whether demand would drop significantly, as even though the break point has lowered, in this case it would take the business a significantly longer time to reach this point due to a drop in demand.

Example 2: Break even diagram to show the impact on the break-even point of an increase in fixed costs



In this case, the fixed costs of the business have increased from £60 to £70. This has increased the total costs which has resulted in the amount needed to be sold to break even (the break-even output) increasing from 60 units to 70 units. In the case, if the business anticipates that its fixed costs are going to rise, which would ultimately make it harder to break even and therefore become profitable, it may look for different ways to become more efficient to lower costs, to overcome this change.

Calculating break even using the formula

Rather than drawing a break even diagram to calculate the break-even point each time, a quicker and more efficient method of calculating break-even is to use the formulae. The break-even formulae are shown in the box:

$$\text{Break even output} = \frac{\text{fixed cost}}{(\text{sales price} - \text{variable cost})}$$

This will give you the number of units the business needs to produce and sell to break even

$$\text{Break-even point in costs/revenue} = \text{break-even point in units} \times \text{sales price}$$

This formula can be used to calculate the revenue (or costs!) at the breakeven level of output

Break even output using the formula

In order to calculate the break-even output using the formula, three variables are required. These are fixed costs, sales price and variable cost per unit.

In example 2, the original fixed costs of the business were £60.

The current variable cost per unit is £1. Variable costs are not drawn directly onto the break-even chart. However, this value can still be calculated if total costs and fixed costs are known and the formula here is used:

$$\text{Total variable costs} = \text{total costs} - \text{total fixed costs}$$

From reviewing the chart, at an easy to read point, i.e. 10 units, the original total costs were £70 and the original total fixed costs were £60. Total variable costs at this level of output therefore = £70 - £60 = £10.

To calculate the variable cost per unit, the number of units just needs to be divided into this amount = £10/10 = £1.

In order to calculate the sales price or the selling price per unit, a similar method can be applied. At an easy to read point i.e. 10 units, the total sales revenue = £20. To calculate the sales price or selling price per unit, the number of units just needs to be divided into this amount = £20/10 = £2.

We now have all the variables required to calculate the break-even output level using the formula as shown:

$$\text{Break even output} = \frac{\text{fixed cost}}{(\text{sales price} - \text{variable cost})} = \frac{\text{£60}}{\text{£2} - \text{£1}} = 60 \text{ units}$$

This being the same answer as obtained from the break-even chart.

Break-even point in costs/revenue using the formula

We will use example 2 again to illustrate how to calculate the break-even point in costs/revenue. A reminder of the formula is:

$$\text{Break-even point in costs/revenue} = \text{break-even point in units} \times \text{sales price}$$

The original break-even point in units = **60 units x £2 (sales price) = £120**. This again shows the same value on the “y” axis for costs/revenue in £s as the break-even diagram, at the break-even point.

The benefit of using break even analysis to a business

- ☒ Break-even is a very useful business tool, as it can quickly illustrate what happens to a firm's profits at different output levels. This can help a business with decision-making about cost levels and selling prices.

- ☑ A business could create a series of break-even diagrams to illustrate the impact on the break-even point if one of the variables on the graph changed. This is called “what if” analysis.

Break even does however have limitations:

- ☒ It assumes that the average price that goods sell at will stay the same.
- ☒ It gives the impression that just because products are produced that they will be sold at the average price.
- ☒ It can become very complicated to a business which sells many different products.
- ☒ It assumes that variable costs are proportional to output, whereas they may get cheaper as output rises or more expensive if workers have to be paid overtime.
- ☒ It may mean that the business focuses on breaking even rather than making a profit!

Cash and cash-flow

Cash-flow describes the movement of cash into and out of a business. It is **not** the same as profit. Many profitable businesses fail because they do not have enough cash to pay their bills. This is because profit is recorded straight after a sale, whereas cash is recorded when it is either spent or received by the business. If a business offers trade credit to a customer for example, of 30 days, then the sale and therefore profit is documented when the goods are taken by the customer, but the cash will not be recorded until payment i.e. the cash is received 30 days later!

In business, cash is always on the move...

- **Cash-flows into the bank account** when customers pay for their sales, when a loan is received from the bank, interest is received or when assets are sold
- **Cash-flows out of the bank account** when suppliers are paid, employee wages and salaries are paid, interest is paid to the bank and so on...

You need to be able to distinguish between:

- **Cash inflows:** movements of cash **into** a business
- **Cash outflows:** movements of cash **out of** the business

The difference between the **cash inflows** and **cash outflows** during a specific period, for example a week or a month is known as the “**net cash-flow**”.

$$\text{Net cash-flow} = \text{cash inflows} - \text{cash outflows for a given time period}$$

The challenge for any business, particularly new businesses, is to manage its net cash-flow successfully, so that the business does not run out of money.

Main types of cash inflow and outflow

The main types of cash-flow can be summarised as follows:

Cash inflows	Cash outflows
Cash sales	Payment of overheads, wages and salaries
Receipts from trade customers	Payment of suppliers, for example raw materials, inventories
Sale of spare assets	Buying equipment
Investment of share capital	Interest on bank loan or overdraft
Personal funds invested	Payment of dividends
Receipt of bank loan	Repayment of loans
Government grants	Income tax, VAT and corporation tax

Why businesses suffer cash-flow problems

Start-up and small businesses are especially vulnerable to cash-flow problems. The reasons for this can be divided into two types:

- not enough money coming into the business fast enough
- too much money going out of the business too quickly

In addition, if a business does have cash-flow problems then new businesses or businesses facing financial difficulties will often not have reserves of **retained profits** to see them through until things improve. If a business runs out of cash and is not able to obtain new finance, it will become **insolvent**.

If a business has a positive cash-flow it will build up **cash reserves**. This can be saved in case of future problems or used for future investment.

The cash-flow forecast

The cash-flow forecast **predicts** the net cash-flows of the business over a future period. It can be used to identify likely **cash-flow problems** and help avoid or solve them.

The forecast estimates what the cash inflows into the bank account and outflows out of the bank account will be. The result of the cash-flow forecast is also an estimate of the bank balance at the end of each period covered (normally this is for each month). An example of a simple cash-flow forecast is shown below:

£'000	January	February	March	April	May	June
Cash inflows	200	250	200	150	100	250
Cash outflows	250	300	300	100	250	150
Net cash-flow <i>(cash inflows – cash outflows)</i>	(50)	(50)	(100)	50	(150)	100
Opening balance <i>(same figure as the closing balance for the previous month)</i>	250	200	150	50	100	(50)
Closing balance <i>(net cash-flow + opening balance)</i>	200	150	50	100	(50)	50

As can be seen from the table, the closing balance becomes the opening balance for the next month. This is then added to the net cash-flow for that month, which may be a positive (April) or negative (May), in order to calculate the closing balance for that month. The closing balance each month might be a surplus, which means the business has a positive cash balance at the end of the month, or a deficit, which means that the business has a negative cash balance at the end of the month (often indicated by brackets, as in May).

Looking at this cash-flow forecast a little more carefully, it shows that the business will start the period, i.e. January, with a cash surplus or opening balance of £250,000. During the first three months, the net cash-flow is negative, as it is predicted that there will be more cash outflows than inflows, which will reduce the closing balance surplus to £50,000 in March. In April and June, the cash outflows are estimated to reduce considerably making them less than the cash inflows, resulting in a surplus in the closing balance in those two months. In May again, the outflows are predicted to be higher than the cash inflows. The opening balance, of £100, is not enough to cover this increase and therefore the business is forecasted to go into a deficit of £50,000.

Businesses must carefully monitor when the business is forecast to experience a deficit, as this highlights the business may run out of cash!

To recap the key formulae for cash-flow forecasts are:

Net cash-flow = cash inflows – cash outflows in a given period

Opening balance = closing balance of the previous period

Closing balance = opening balance + net cash-flow

Why the cash-flow forecast is so important

A business uses a cash-flow forecast to:

- **Identify potential shortfalls in cash balances in advance** – think of the cash-flow forecast as an “early warning system”. This is the most important reason for a cash-flow forecast and enables the business to take action, so that it does not experience any cash-flow issues, which can ultimately prevent the business from trading and becoming insolvent

- **Makes sure that the business can afford to pay suppliers and employees** - suppliers which do not get paid will soon stop supplying the business; it is even worse if employees are not paid on time, as in this case there would be no-one to either produce the goods or provide customers with the level of service that they demand
- **Spot problems with customer payments** – preparing the forecast encourages the business to look at how quickly customers are paying their debts. This is only an issue in some businesses and not all. For example, most retailers take most of their sales in cash/credit cards at the point of sale i.e. at the time of purchase
- **Compare actual figures to forecast figures** – this allows management to spot if there are any potential issues and take appropriate action, for example if there are significant differences between the forecasted figures and the actual figures, a business owner would need to arrange appropriate sources of finance to cover any shortfalls in cash
- **External stakeholders, such as banks, may require a regular forecast** - certainly if the business has a bank loan, the bank will want to look at the business cash-flow compared to its forecast at regular intervals, to ensure that the business will continue to make its repayments

Main causes of cash-flow problems

A **cash-flow problem** arises when a business struggles to pay its debts as they become due. When cash-flow is consistently negative and the business uses up its cash balances, then the problem becomes serious. The main causes of cash-flow problems are:

Factor	Why it causes a cash-flow problem...
Low profits or (worse) losses	There is a direct link between low profits or losses and cash-flow problems. Remember, most loss-making businesses eventually run out of cash
Over-investment in capacity	This happens when a business spends too much on machinery, equipment or premises. Factory equipment, which is not being used, does not generate revenue, so is often a waste of cash
Too much stock	Holding too much inventory or stock ties up cash and there is an increased risk that these inventories become obsolete i.e. cannot be sold and therefore cannot generate any cash inflows
Allowing customers too much credit	Offering credit to customers, i.e. buy now and pay later, is a good way to build customer loyalty and long-term revenue, but late payment is a common problem and slow-paying customers put a strain on cash-flow
Overtrading	This occurs where a business expands too quickly, putting pressure on short-term finance. For example, a retail chain might try to open too many stores too quickly, before each starts to generate profits
Seasonal demand	Predictable changes in seasonal demand create cash-flow problems, but because they are expected, a business should be able to handle these in an appropriate way

Sources of business finance

A start-up or existing small business will need finance. They will need it for various reasons, short term and long term. There are different sources of finance available and the actual source chosen by a business will depend on the amount and reason the finance is required, as well as the circumstances and the type of legal status the business has.

The challenge of raising money

Often the hardest part of starting a business is raising the money to get going.

An entrepreneur might have a great business idea and clear plan for how to exploit a market opportunity. However, unless sufficient finance can be raised, the entrepreneur will struggle to make the most of the opportunity.

Raising finance for a start-up requires careful planning. The entrepreneur needs to decide:

- **How much finance is required?** Raising finance is hard work and expensive – a start-up business should avoid having to go through the process too often!
- **When and for how long the finance is needed?** A useful distinction can be made between long-term and short-term finance
- **What security (if any) can be provided?** This will affect the ability of the business to raise a bank or other loan where the lender requires some security (or “collateral”)
- **Whether the entrepreneur is prepared to give up some control** (ownership) of the start-up in return for investment
- **Whether the cost of the finance**, for example the interest charged, is justified

The finance needs of a start-up should also take account of these key areas:

- **Set-up costs:** the costs that are incurred before the business starts to trade
- **Getting ready to produce:** the fixed or long term assets that the business needs before it can begin to trade, such as machinery, equipment, vehicles etc
- **Working capital:** money required for the day to day operation of the business. Money will be needed by the business to buy the stocks required by the business, such as raw materials, and allowance should be made for amounts that will be owed by customers once sales begin, if the business chooses to offer its customers trade credit
- **Growth and development:** in the future the business may wish to grow and expand and therefore will need to invest in extra capacity, for example in extra space to produce more products

Finance to cover different periods

An important consideration when obtaining finance for a business is when and for how long the finance is needed. A useful distinction can be made between long-term and short-term sources of finance. The table summarises the main examples and uses of each category:

Long-term	Short-term
Finances the whole business over many years	Finances day-to-day trading of the business; repayable usually within a year
Examples:	Examples:
☒ Personal savings ☒ Retained profits ☒ Share capital ☒ Venture capital ☒ Bank loans ☒ Crowd funding	☒ Bank overdraft ☒ Trade credit

Short-term sources of business finance:

Trade credit

This is used by many businesses as a short-term source of finance. Trade credit essentially means that a firm's suppliers will allow it to have the goods and pay for them at a later date.

- ☒ This can give time for the business to use the goods and sell its products before it pays the suppliers, which will improve its **cash-flow** position.
- ☒ If the bills are not paid on time however, this can lead to the business getting a bad reputation and losing future credit arrangements with the supplier.
- ☒ It can also be particularly difficult for new start-up businesses to negotiate trade credit with suppliers, as there is a risk that the business will fail and suppliers may end up not getting paid!

Bank overdraft

Businesses of all sizes use bank overdrafts as a means of finance. As a business gets bigger, it often finds that its overdraft facility also needs to grow. That is because an overdraft is essentially a short-term source of finance that is available to help fund the day-to-day payments required by a business. It allows the business to withdraw funds from its account that are not there, up to an agreed maximum limit, and is only used when the business requires additional, temporary amounts of money.

- ☒ The big advantage of a bank overdraft is its flexibility. If a business experiences a short-term shortage of cash or an unexpected cost, then it can be paid by using some of the overdraft facility. Interest is only paid on the amount used.
- ☒ The main downside of an overdraft is that it is repayable to the bank at any time. A business may have an overdraft facility of £100,000 i.e. it can owe the bank up to that amount, but the bank may lower or even withdraw that facility at any time. This happened to numerous businesses with bank overdrafts during the credit crunch of 2007-8, many of whom were relying on their overdraft to stay in business.
- ☒ The other drawback of an overdraft is that they usually have high levels of interest attached to them, making them an expensive form of finance when they are used.

Long-term sources of business finance:

Personal savings

An entrepreneur will often invest personal cash balances into a start-up. This can be personal savings from the bank or building society. This can also be in the form of providing assets for the business, for example using an own car, or it can be as simple as **working for nothing!** By using this source of finance, the entrepreneur is providing a strong signal, to other potential investors and the bank, of his/her commitment to the business venture.

- ☒ This is a cheap form of finance that is readily available.
- ☒ Investing personal savings maximises the **control** the entrepreneur keeps over the business.
- ☒ The amount that is available may be limited, resulting in this being used with other sources of finance to fund the business.

Loans

These might be from friends and family or from financial institutions, such as a bank.

Friends and family:

Friends and family who are supportive of the business idea may be willing to provide money either directly to the entrepreneur or into the business.

- ☒ This can be quick and cheap to arrange (certainly compared with a bank loan).
- ☒ The interest and repayment terms may be more flexible than a bank loan.
- ☒ However, borrowing in this way can add to the stress faced by an entrepreneur, particularly if the business gets into difficulties, as it can cause disagreements.
- ☒ The amount available may be limited, resulting in this being combined with other sources of finance.

Bank loan:

A bank loan is an amount of money borrowed for a set period with an agreed repayment schedule. The repayment amount will depend on the size and duration of the loan and the rate of interest. This is a common source of finance that a small or new business would choose. However, bank loans tend to be more readily available for well-established and growing businesses, rather than start-up businesses. The reason for this is **risk** – banks prefer to loan to successful businesses, which makes them more likely to be able to repay the loan and interest.

If a bank loan can be obtained then there are several advantages for a start-up or an established small business:

- ☒ The business is **guaranteed** the money for a certain period - generally three to ten years (unless it breaks the loan conditions).
- ☒ Loans can be **matched** to the lifetime of the equipment or other assets the loan is being used for
- ☒ While interest must be paid on the loan, there is no need to provide the bank with a share in the business, so **no control is lost**.
- ☒ **Interest rates may be fixed** for the term, making it easier to forecast interest payments and cash-flow.
- ☒ Repayments are made in **instalments**, resulting in the business having access to substantial amounts of cash that does not need to be paid back all in one-go.

There are also some disadvantages of a bank loan:

- ☒ **Time consuming** - a new business would need to produce a detailed business plan to show to the bank in order to secure the loan, which would take up time and resource; however it could be argued in the long-run, that this careful planning would help the business to have a greater chance of success in the future.
- ☒ **Security** - normally has to be given to the bank on some of the assets of the business. The bank will have control over these assets if the business fails.
- ☒ **Lack of flexibility** - a small business might take a loan out for £50,000 but finds it only needed £30,000. That means that interest is being paid on £20,000 of loan that it does not need.
- ☒ **Interest** – interest must be paid on the loan amount, which increases the costs of the business.

Venture capital

Venture capitalists often invest in small businesses. Venture capital can be gained from professional investors or companies who typically invest between £10,000 to £750,000.

Venture capitalists tend to have made their money by setting up and selling their own business – in other words they have proven entrepreneurial expertise. The advantages and disadvantage of this source of finance are:

- ☑ Venture capitalists often make their own skills, experience and contacts available to the firm.
- ☑ They have access to large amounts of funds.
- ☒ The venture capital company or investor will usually want a share of the business and of the profits, which can result in some loss of control over the firm for the entrepreneur, which he/she may not want to give up.

Obtaining venture capital is quite different from raising debt or a loan from a lender, such as a bank. Lenders have a legal right to interest on a loan and repayment of the capital, irrespective of the success or failure of the business. By contrast, venture capital is often invested in exchange for a stake in the company where the **return will be dependent on the growth and profitability of the business**.

Not every business is suitable for investment by a venture capitalist. Such investors prefer to invest in small **entrepreneurial** businesses which are aiming (and have the potential) for sales and profit growth. As a rough guide unless a business can offer the prospect of significant turnover growth within five years, it is unlikely to be of interest to a venture capital firm.

Share capital

Small or new businesses that are set up as a private limited company can raise finance by selling shares in the company. There are many **advantages** to a business of raising finance through share issues:

- ☑ Large sums of money can be raised.
- ☑ Capital does not have to be repaid.
- ☑ There is no interest – dividend payments can be missed if profits are low.

There are however some **disadvantages** including:

- ☒ Possible loss of control if the original owners sell more than 50% of the total shares.
- ☒ Need to satisfy shareholders expectations of dividends and share price growth.

Retained profit

This is a very important source of finance for an existing small business, but is clearly not suitable for a new business, as they are yet to build up reserves of profit!

The idea is simple. When a business has worked out its profits, the owners or shareholders can decide whether to take the profits for themselves or reinvest the profits back into the business.

Retained profits have several major advantages:

- ☑ They are cheap, as no interest has to be paid on them.
- ☑ They are very flexible – the business owners have complete control over how they are reinvested and what proportion is kept, rather than paid as dividends.
- ☑ They do not dilute or reduce the ownership of the organisation, so for companies there is no increased risk of a takeover.

There are, however, also some disadvantages:

- ☒ If a business needs some temporary finance because it is facing difficulties, then it is unlikely to have any profits that it can use.
- ☒ Growth may be slow if it is dependent on retained profits, as profits may not be high enough to finance the growth quickly.

Crowdfunding

Crowdfunding is a recent way of small businesses or projects raising money from outside investors, often through the internet or a crowd funding platform such as www.kickstarter.com or www.crowdfunder.co.uk

A proposal is publicised and the aim is that a large number of small investors will be attracted from all over the world. The investors will generally be in sympathy with the aims of the project or the cause for which the funds are being raised.

There are some advantages to a business of using crowdfunding to secure finance:

- ☑ It provides cheap investment when other sources of external finance may not be available.
- ☑ If the project is interesting or newsworthy it might attract good publicity, which will help the business in becoming successful.
- ☑ The business may create a web blog or use social media to keep investors informed, which might provide ongoing finance.
- ☑ Investors may have experience or skills that they can offer the business.

There will however be drawbacks:

- ☒ Investors will need to be offered a return; this might be free use of the good or service produced, or a share in the profits. Some schemes will also provide shares, which therefore dilutes the control of the original owners of the business.
- ☒ There is a risk that there will be a limit to the amount of money investors are willing to use in this way.