

# Financial planning

The main aim of this part of the specification is to look at the key financial concepts essential for the planning of small businesses.

## Calculating costs, revenues and profits

The costs that a business faces can be split into two types.

**Definition: Variable costs (VC)** are costs that vary directly with output. The more that is produced, the higher the variable costs will be.

Examples of variable costs include:

- ▶ Raw materials
- ▶ Wages (paid per hour, per day or per week)
- ▶ Power to make the actual product

**Definition: Fixed costs (FC)** are costs that do not vary directly with output.

Examples of fixed costs include:

- ▶ Rent
- ▶ Business rates
- ▶ Salaries (annual, but paid monthly)
- ▶ Marketing expenses
- ▶ Lighting and heating
- ▶ Administration

The firm must calculate the total costs that it needs to meet:

**Total costs = Fixed costs + Variable costs**

**Definition: Price** is the amount paid by a consumer to purchase one unit of a product.

A business needs to set a price for a product that:

- ▶ Covers the costs of making that product
- ▶ Attracts customers
- ▶ Generates a profit

**Definition: Total revenue** is a measure of the income received from an organisation's activities.

Total revenue may be described as income, revenue, sales revenue, sales turnover or turnover.

**Total revenue = Price × Quantity of units sold**

**Definition:** Profit is the difference between the income of a business and its total costs.

**Profit = Total revenue – Total costs**

**Definition: Profit margin** is the difference between the selling price of an item and the cost of making or buying that item.

Firms can look to increase their profitability in three main ways:

- ▶ Increase the price they charge per unit and maintain the current amount of sales and costs
- ▶ Lower their fixed costs and maintain sales
- ▶ Lower their variable costs and maintain sales

## Using breakeven analysis to make decisions

**Definition: Breakeven (BE)** is the number of units that needs to be sold in order for total revenue to equal total costs.

At this point the business neither makes a profit nor a loss. Firms will want to know this figure as they can use this for their planning and will know when they start making profits.

The formula to calculate breakeven is as follows:

$$\text{Breakeven} = \frac{\text{Fixed costs}}{\text{Price} - \text{Variable cost per unit}}$$

or

$$\frac{\text{Fixed costs}}{\text{Contribution per unit}}$$

**Definition: Contribution** is the difference between the selling price per unit and the variable cost per unit.

$$\text{Contribution} = \text{Price} - \text{Variable cost per unit}$$

Each unit sold will make a contribution to the fixed costs of a business as long as the price charged at least covers the variable costs of making that particular unit.



For example, if a business sells bottles of coke for £1.00 and the variable cost per unit is only 40p, the contribution = 60p per unit.

**Definition: Margin of safety** is the difference between the current level of sales and the breakeven level of sales. In other words, it indicates how much the sales level can fall before a business reaches its breakeven point.

For example, if the current level of sales is £10,500 and the breakeven level of sales is £6,500, the margin of safety is £4,000.

Margin of safety can also be expressed in terms of output. For example, a firm might currently sell 5000 units a week while the amount it needs to sell to breakeven is 3000 units a week. The margin of safety is therefore 2000 units.

**EXAM TIP**

Many students struggle with the concept of breakeven and it is likely that you will have spent a number of lessons in class on this area. The examiner will look to test your ability to calculate the breakeven figure from the data in the case study. While you may be asked to draw or complete a breakeven graph, it is unlikely that you will be expected to do this on the paper itself. It is more likely that you will be expected to use the formula. However, the data will often be hidden within the case study – you need to identify the different costs and then use the formula. You might also be expected to recalculate the breakeven formula if costs rise or the price changes. This is known as what-if analysis.

**NUMBER CRUNCHING**

Crew Co. has annual fixed costs of £60,000, sales of 4500 units, variable costs of £5 per unit and a selling price of £25.

**(a) What's the annual profit?**

Total revenue =  $4500 \times £25 = £112,500$   
 Fixed costs = £60,000  
 Variable costs =  $4500 \times £5 = £22,500$   
 Total costs =  $£60,000 + £22,500 = £82,500$   
 Profit = Total revenue – Total costs =  $£112,500 - £82,500$   
 Profit = £30,000

**(b) What is the breakeven point by volume and by value?**

Breakeven by volume:

$$\frac{\text{Fixed costs}}{\text{Price} - \text{Variable cost per unit}} = \frac{£60,000}{£25 - £5} = 3000 \text{ units}$$

BE by value =  $3000 \times £25 = £75,000$

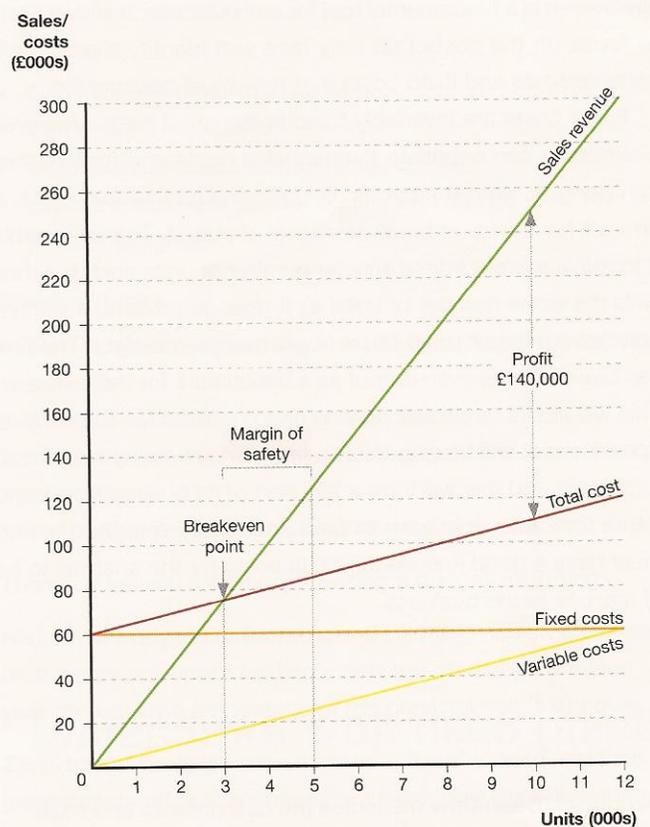
**(c) Calculate the profit next year if sales rise to the budgeted level of 5,200 units.**

Total revenue =  $5200 \times £25 = £130,000$   
 Fixed costs = £60,000  
 Variable costs =  $5200 \times £5 = £26,000$   
 Total costs =  $£60,000 + £26,000 = £86,000$   
 Profit = Total revenue – Total costs =  $£130,000 - £86,000$   
 Profit = £44,000

**(d) Calculate the profit next year if sales rise to 5200 units and variable costs increase by 20% per unit.**

Total revenue =  $5200 \times £25 = £130,000$   
 Fixed costs = £60,000  
 Variable costs =  $5200 \times £6 = £31,200$   
 (20% increase = VC now £6 instead of £5)  
 Total costs =  $£60,000 + £31,200 = £91,200$   
 Profit = Total revenue – Total costs =  $£130,000 - £91,200$   
 Profit = £38,800

- (e) (i) Plot the original total cost line on the graph.
- (ii) Mark the breakeven point and show the margin of safety in units, assuming sales of 5000 units.
- (iii) Use the graph to estimate profit/loss at 10,000 units.





### Advantages of breakeven analysis

- ▶ Fairly simple to understand
- ▶ Useful for new companies to see how much they need to produce
- ▶ Companies can use what-if analysis and see how much they need to sell to break even
- ▶ Linked to market research on probable sales in order to predict profit
- ▶ Easy to calculate

### Problems with breakeven

- ▶ All figures are just estimates
- ▶ Fixed costs may not stay the same – as firms grow, they may need to move to larger premises, changing the fixed costs
- ▶ Assumes that all output is sold
- ▶ Variable costs are unlikely to stay the same – as output grows, economies of scale will kick in and lower the unit cost
- ▶ Fails to take into account price elasticity – changes in price will cause different effects on the demand for different products

### A-GRADE ANALYSIS EXAMPLE

Breakeven is a fundamental tool for any business. It allows firms to focus on the costs that they face and identify the different variable costs and fixed costs that they must account for.

Fixed costs are invariably fixed in the short term. However, businesses can negotiate their variable costs and for this they can perform what-if analysis. By lowering its variable costs, a firm will have a lower breakeven level of output. This will enable it to make a profit from a smaller number of units sold. If it then sells the same number of units as it does at present, it will not only have a larger profit but a larger margin of safety. The firm can use the breakeven output as a benchmark for the business. This will aid its target setting and give it a focus for its business operations. It will have a clear idea as to how many units need to be sold and this will form a key part of its business plan and future forecasts. It is easy to calculate breakeven, but the firm must have a good knowledge of its costs for the analysis to be of any use to the business.

## Using cash flow forecasting

**Definition:** Cash flow measures the cash inflows and cash outflows over a period of time.

The cash flow forecast will predict the expected cash in and out over a period – normally a year.

### Usefulness

The cash flow forecast will form an essential part of the business plan. It will help the firm identify areas where it might need extra sources of finance and also when its busy periods are likely to be.

### Sources of information for cash flow forecasts

- ▶ Market research findings
- ▶ Suppliers – information on costs and credit terms
- ▶ Business Link
- ▶ Banks

### Causes of cash flow problems

- ▶ Seasonal demand
- ▶ Over-estimation of sales or under-estimation of costs
- ▶ Over-investment in fixed assets – firms may invest in assets such as buildings and machinery, but not leave themselves sufficient money for day-to-day payments
- ▶ Credit sales – the marketing department will want to give credit to customers to attract them to the company, but this can lead to a shortage of cash
- ▶ Poor stock management
- ▶ Unforeseen change

### Possible solutions

- ▶ Arrange an overdraft with the bank
- ▶ Sell off some of the company's assets
- ▶ Sale and leaseback – sell some assets and then rent them back
- ▶ Change or review suppliers
- ▶ Extract less cash from the business (pay lower wages)
- ▶ Manage debtors

### EXAM TIP

Cash flow forecasting is vital for any business and particularly for a new business start-up. As the exam is likely to be based on an entrepreneur setting up a new business venture, it is highly probable that you will be examined on this topic. In class you will have looked at completing forecasts and there may be a question asking you to do this. However, a more probable focus for questions and a more challenging area is to explain how the forecast is likely to be used by the entrepreneur. Look at the *Grade-A Analysis/Evaluation Examples* below to see how this is done.



### NUMBER CRUNCHING

	Jun	Jul	Aug	Sep	Oct	Nov
Cash at start	100	120		110	100	90
Cash in	60	70			80	100
Cash out	40		100	90		70
Net cash flow		10	(20)			
Cash at end	120			100	90	

Complete the cash flow forecast. In the exam you might be expected to complete no more than three missing items.

### A-GRADE ANALYSIS EXAMPLE

There are certain ways in which a business can improve its cash flow position. It can reduce the amount of credit that it offers its customers, for example, or possibly offer discounts for cash payments. The business will benefit from additional cash, even though it might have offered a discount of 10% in terms of value. The result will be a greater influx of cash in the short term.

In addition, the firm may look to delay payments to suppliers by seeking longer payment terms – perhaps expanding the time it has to pay from 28 days to 56 days. This may mean that it can sell the goods before payment is required, transforming the firm's cash flow position.

### A-GRADE EVALUATION EXAMPLE

Cash flow forecasting is a vital part of the success of any business. The timing of cash into and out of a business is fundamental to its future. If the money flowing out is greater than the money coming into the firm, then it will have difficulties. It may be possible to arrange an overdraft to cope in the short term, but if this can be avoided it will be better for the firm. Keeping track of the money coming in will allow a firm to budget accordingly and help identify when it might need the extra finance available. Such a cash flow forecast will need to be presented to the bank if an overdraft or loan is required. If a business is cash poor, then it may face future difficulties as a result of suppliers being less willing to supply. Such a supply problem could damage the firm's relationship with its customers.

Cash flow is clearly vital. While a business may be potentially highly profitable in the long term, if the firm does not have enough cash in the short term it may not prove viable. It is essential for a firm to keep a close eye on its finances, and cash flow forecasting is a key part of this process.

It may be difficult for new business start-ups to secure longer credit terms until they have become more established. This is one of the reasons why so many new firms fail in their first year.

## Setting budgets

**Definition:** A **budget** is a financial plan, establishing the policy to be pursued and the anticipated outcomes of that policy.

### Types of budget

- ▶ Sales or income budget
- ▶ Expenditure budget (this will set spending limits so that costs do not get out of control)
- ▶ Profit budget

### Reasons for having a budget

- ▶ To ensure that no department has an overspend
- ▶ Sets targets against which performance can be judged
- ▶ Delegates spending power to individuals or departments

### The budget process

- ▶ Set clear objectives for the coming year
- ▶ Gather information and market research data in relation to sales
- ▶ Construct a sales budget showing target revenues
- ▶ Set a budget for major cost areas
- ▶ Set a profit target based on the sales and cost budgets already calculated

### Advantages

- ▶ Can measure performance
- ▶ Can prove motivational
- ▶ Makes departments accountable
- ▶ Gives the business greater control and can be used to monitor progress

### Disadvantages

- ▶ New business start-ups lack experience in setting realistic budgets
- ▶ Costs are volatile and can change quickly
- ▶ Opportunities might be missed if budgets are applied too strictly
- ▶ If a budget is inaccurate, it can demotivate staff

There are several methods of setting a budget, including:

**Historical budgets** or **incremental budgets**, which are based on the previous year's trading – they are normally increased year on year by a percentage of the previous year's turnover.

**Zero-based budgets**, which are initially set at zero and then departments pitch to management explaining their budgetary needs.



### EXAM TIP

The topic of budgets is developed further in Unit 2 of the specification, where variance analysis is covered. While it is more likely to be examined in this second unit, questions do frequently come up in the Unit 1 exam on the difficulties and limitations of setting budgets.

### A-GRADE ANALYSIS EXAMPLE

As a new firm will have very little experience of setting budgets, the sales targets may be ambitious and therefore inaccurate. This can lead to over-spending on costs as the expected higher sales simply fail to materialise. This in turn can lead to a worse than expected cash flow position which, if not addressed, might result in the firm finding it hard to pay suppliers for stock. The business could even go under.

It is also very difficult to research accurately the potential sales of a business if it is operating in a brand new market. The sample size in the research is particularly important because if it is not sufficiently representative, it may lead to further inaccuracies in terms of the budgets. This might then affect the management projections and lead to excessive outflows.

### A-GRADE EVALUATION EXAMPLE

It is very difficult for a business to set an initial budget. If the firm is to succeed, then it is vital that as much research as possible is undertaken. This may prove expensive to begin with, at a time when the firm is in its early stages and finance is limited. However, I believe that, by setting the budgets as accurately as possible in the first instance, it will greatly reduce the risk of failure and make the budgets more useful in terms of monitoring and reviewing progress. Seeking advice and assistance from someone who has experience of the budget process, such as a bank manager, would be valuable.

## Assessing business start-ups

This part of the specification brings together all of the previous aspects of study. It looks at the different ways in which success can be measured. Start-ups will normally be judged against the business objectives that they set themselves.

Good and effective objectives for a business will be **SMART**:

- ▶ Specific
- ▶ Measurable
- ▶ Agreed
- ▶ Realistic
- ▶ Time specific

## Possible causes of business failure

- ▶ Lack of business and management skills
- ▶ Insufficient finance
- ▶ Poor location
- ▶ Poor planning
- ▶ External factors:
  - Competition
  - Increased costs, e.g. increased taxation or interest rates
  - Changes in consumer tastes
  - New technology

### EXAM TIP

As this is a synoptic part of the specification, it will draw together many aspects of the course so far. Make sure that, rather than listing lots of points and failing to develop them all, you choose a couple of areas and develop a few arguments fully.

### A-GRADE EVALUATION EXAMPLE

The potential rewards of setting up your own business are great. By being your own boss and making your own decisions, you can take your business in the direction you wish. The success of the business will be in your control and you will be directly responsible for the decisions that you make. The business, if profitable, will benefit you personally as you will probably be one of the major shareholders within the firm. If a dividend is issued to shareholders, you are likely to benefit financially.

However, the rewards must be balanced against the risks. If the firm struggles or fails, the individual setting up the business is likely to be placed under considerable stress and, if there is unlimited liability, the owner will be personally liable for all of the debts incurred by the firm. This can be potentially very damaging. If the firm fails and goes into bankruptcy, the individual will not be allowed to set up and run his or her own business for a period of 18 months.

In conclusion, the individual setting up a business will most likely be driven to succeed. The use of a business plan will be very important for the firm and, if a potential gap in the market is identified, then the rewards will be particularly high. By running your own business, rather than operating as a franchise or as part of a larger company, you can enjoy all of the benefits yourself rather than having to share them with a parent company.

The true measure of success of a business start-up will be based on the actual product or service that the firm is offering. For a firm to be successful, the product or service must exploit an opportunity and satisfy customer demand. If the product or service is not very good, then no amount of cash flow forecasting or budgeting can guarantee the future success of the business.



# Exam practice

## Case study 1: Urban Truant

Greg Wilson was a successful IT consultant with a dream. He wanted to leave IT consultancy and run his own business, a business that would not only give him a livelihood but would actually be fun!

After several sailing holidays, he decided that he could run a potentially profitable business by setting up a sailing venture. He came up with the concept of Urban Truant. Greg figured that people would be keen to escape the office to try out sailing and that he could offer charters to upmarket business people who would be willing to pay a premium price.

Greg had identified a location operating out of the Hamble marina just outside Southampton. This marina has a good infrastructure and an excellent reputation. However, it is also the home to a number of established sailing schools that offer a similar style of business to Greg's. Having conducted secondary research into his potential competitors and the prices that they charged, Greg believed he would be able to charge a slightly higher price because of his USP – a sailing experience combined with excellent food.

In terms of staffing, Greg felt that he could offer a high-class service by using his sailing experience and the culinary expertise of his partner, Laura. Operating one boat initially, he thought he would not require any additional help.

Greg looked into the cost of buying a boat and quickly realised that this would not come cheap. A new boat would cost £400,000 and to purchase items such as dry suits, life jackets and other necessary items would cost a further £20,000. Once marketing costs were added, even though Greg planned to use his contacts in the business world, he could see that he was likely to need £500,000 just to get the business off the ground. He started putting together a business plan to take to his bank manager and he drew up a cash flow forecast (Figure 1).

While Greg had substantial savings from his IT work, he was reluctant to put all of these into a new project that could potentially lose him a lot of money. Neil, one of his former contacts, was willing to invest £100,000 for a 15% stake in the business. He believed that they should go into partnership and was keen to have a deed of partnership drawn up. Greg was concerned that this would still mean that they had unlimited liability.

Figure 1 Greg's initial cash flow forecast (£000s)

	April	May	June	July
<b>Cash in:</b>				
Savings and investment	500	0	0	0
Sales	20	60	80	100
<i>Total cash in</i>	520	60	80	100
<b>Cash out:</b>				
Purchase of boat	400	0	0	0
Purchase of equipment	20	0	0	0
Wages	5	5	5	5
Marketing costs	80	5	5	5
Fuel and running costs	5	15	20	25
Food and other costs	25	35	40	50
<i>Total cash out</i>	<b>W</b>	60	70	85
<b>Cash flow:</b>	<b>X</b>	0	<b>Y</b>	15
Opening balance	10	(5)	(5)	5
Closing balance	(5)	(5)	<b>Z</b>	20

Questions: 60 marks (75 minutes)

### Section A (20 marks)

- 1 What is meant by the term 'infrastructure'? (2)
- 2 What is meant by the term 'deed of partnership'? (2)
- 3 What is meant by the term 'unlimited liability'? (2)
- 4 Using Greg's initial cash flow forecast (Figure 1), calculate the missing figures for W, X, Y and Z. (4)
- 5 Based on the figures provided by the cash flow forecast, calculate the percentage sales growth from May to July. (2)
- 6 Explain the skills required for Greg to make Urban Truant a successful business enterprise. (8)

### Section B (40 marks)

- 1 Analyse two possible benefits of Greg using cash flow forecasts to help set up the business. (10)
- 2 The bank manager was very concerned about the figures that Greg had presented to him and felt that they were unrealistic. He was not convinced that Urban Truant had the potential to be a successful business. To what extent do you agree with this view? (15)
- 3 Greg felt that the key to future success was having the right product or service, in the right location. He believed that his experience of writing business plans would also ensure the success of the venture. To what extent do you agree with him? (15)

**Candidate's response (A grade)****Section A (20 marks)**

**1** 'Infrastructure' refers to the man-made environment. In the case of Urban Truant it refers to the need to have access to a marina, boats and facilities such as washing and changing facilities.

The candidate understands the term and applies it to the business. (2 marks)

**2** This is a legal document that sets out the 'rules' of the partnership, how work and profit are to be shared, and what would happen if the partnership were to be dissolved. It explains clearly 'who' is responsible for 'what' within the business.

Again, really good knowledge shown. (2 marks)

**3** 'Unlimited liability' is when an individual is personally responsible for the actions of the business. The business and individual are treated as one and the same from a legal perspective and if the firm were to get into financial difficulties, the individual's personal possessions would be at risk.

Knowledge of key term understood. (2 marks)

**4**  $W = 535$      $X = (15)$      $Y = 10$      $Z = 5$

All figures calculated correctly. (4 marks)

**5** % sales growth =  $\frac{\text{New} - \text{Old}}{\text{Old}} \times 100$

May = £60,000

July = £100,000

% sales growth =  $\frac{100 - 60}{60} \times 100 = \frac{40}{60} \times 100 = 66.67\%$

All figures calculated correctly. (2 marks)

**6** In order to run a successful enterprise, a number of skills are required. One of the skills Greg has shown is that, having already proved successful as an IT consultant, he has the experience of working with and dealing with people. He also displays a vision in identifying a potential enterprise and is willing to work hard and take risks to make the venture a success. He has the vision to see how he can draw on a personal experience to create a potentially profitable business that can add value. Greg is also keen to use his own personal skills and qualities and that of his partner to offer a unique experience to the UK market.

This is quite a difficult question to answer. The candidate has tried to bring in the skills and qualities that an entrepreneur might possess and relate them to the business. This is a good attempt. (7 marks)

**Section B (40 marks)**

**1** The first benefit is that the cash flow forecast will help Greg secure the finance he requires. Banks are far more likely to lend money to a business that has evidence of financial planning. The forecast will reassure the bank that Greg has thought about the finance required and identified via market research his likely sales and cost figures. This will give the bank greater confidence in Greg and help it assess the viability of the business proposal.

The second benefit is that the forecast will help Greg prepare for periods when cash flow might prove a problem for his business. He will be able to arrange an overdraft facility or an alternative source of finance in order to help him overcome these difficult times.

The first benefit is explained more strongly than the second, as it focuses on the usefulness of forecasting before the business is set up – as the question asks. The second benefit relates to the business once it is up and running and thus drifts away from the question. (5 marks)

**2** The cost of the proposal is substantial. The business would require an initial £500,000 and, by July, the closing balance is only forecast to be £20,000. Given that July is likely to be the busiest period of the year, this does not signify a significant return on the high start-up costs. It is likely to be a very seasonal business and sales will be much lower in the winter months. During this time, fixed costs will still have to be paid and maintenance of the boat itself is likely to be significant. Greg also expects to increase his sales significantly within the first few months of trading and this might be too optimistic.

However, the success that Greg has achieved previously may help allay some of the bank manager's fears. It should also be recognised that the majority of the start-up costs come from the purchase of the boat itself. While the value of the boat will fall over time (similar to a car), it is still an asset that Greg and the business owns, so he would be able to resell this if the business proved unsuccessful. This should give the bank manager greater confidence. Moreover, the bank would know that, if the business were not a success, Greg would be required to pay back any finance raised from his personal possessions.

Given that the cash flow forecast only shows four months of trading, it is difficult to make a full judgement, but I feel that the bank manager is right to have concerns. However, he might be able to suggest other options, such as looking to lease a boat rather than buy one. This would reduce the initial outgoings of the business and, while more expensive in the long run, it may be prudent to take this option.



The candidate has made good use of the figures and the case study, demonstrating strong application. He shows a clear grasp of the key terms, linking them to the data given. The judgement shown is also good, as it suggests what might go wrong and what Greg could do if this were to happen. (13 marks)

**3** Clearly Greg has proved that he has enjoyed success in the past. However, this was in the totally unrelated world of IT. The business plan is an essential part of any successful venture. However, it needs to be used effectively. While Greg has experience in planning, it might be the case that he has let his enthusiasm for sailing cloud his business judgement. The cash flow forecast does not seem that encouraging and it is not clear how much primary market research Greg has conducted. The fact that his secondary research proved that there were a number of established businesses that could potentially adapt and challenge his own is a serious concern.

There is no doubt that a great location is important. However, it does not guarantee success. It is also difficult to measure success fully. Does it refer to profits or other business objectives? Greg is clearly naïve if he believes that his business cannot fail. Other external factors, such as competition or an inability to raise finance, might mean that his attempt to develop his idea proves unsuccessful.

The candidate appears to have run out of time – a common situation. It is vital that you manage your time effectively. However, there are some reasonable points made in this response. Examiners look to mark positively and the candidate has tried to answer the question and make a judgement.

(6 marks)

## Case study 2: Relish

Pippa Sawyer and her business partner, Andy, set up a successful sandwich shop, Relish, in the heart of Cirencester eight years ago. Pippa recognised that in order to grow the brand and build up custom, it was important to identify further areas for development. With Andy's agreement, she decided to offer outside catering opportunities at events such as the Cotswold Show and the nearby Polo club as well as food for Christmas parties and special events such as weddings. By targeting this particular market niche, Pippa was keen to pursue the twin objectives of growth and profit maximisation.

In order to meet the demand for these extra events, Pippa needed to have a flexible workforce and a mixture of full-time and part-time staff as well as using temporary staff during the busy Christmas and summer periods. The Royal Agricultural

College located just outside the town meant that she had a pool of labour willing to work as and when required.

About a year ago, Relish saw an opportunity to move into a vacant public house that was just 50 yards down the street in the centre of the town. This property had three times more kitchen and seating space than Relish's existing location and it gave Pippa an idea to develop the business further. The existing lunchtime trade could still be met by using the new venue to make the sandwiches, but it would also allow her to offer food throughout the day and into the evening. This proved to be very successful and the business operated more efficiently from the new location.

However, the original property was still vacant after six months and Pippa thought about the possibility of opening up another venture on the old site. Having conducted some initial primary research by talking to friends and observing where other restaurants were located in the town centre, she identified the absence of a major burger restaurant as an opportunity. Pippa looked into two possible options:

*Option 1:* Setting up an independent American-styled diner to sell burgers and milkshakes using suppliers that she used for her existing sandwich and pub business

*Option 2:* Becoming a franchise using an established multinational brand

After researching the costs of setting up a franchise, Pippa felt that Option 1 would prove potentially more profitable and also give her greater control. However, she was concerned about the financial implications, having recently moved into the new, larger premises. Cash flow was going to be an issue and so she prepared a forecast as part of her business plan, in preparation for a meeting with her bank manager.

Pippa estimated that the initial cost of setting up the new burger bar venture would be £150,000. She proposed to finance this using the profits that she had made from the other parts of the Relish business as well as putting in £25,000 of her personal savings, a figure which she hoped would be matched by Andy. They were both keen to establish the expanding business as a private limited company rather than as a business partnership, but he was less sure about the new venture and felt that alternative sources of finance might be more appropriate – possibly from a venture capitalist.

Pippa prepared a budget for the business based on some quantitative research she had carried out into the costings of the new burger bar. She was looking to sell each meal for an average price of £5 and had calculated her variable costs to be £2 per meal.

**Figure 1** Pippa's budget forecast for the burger bar (£000s)

	2012	2013	2014	2015
Budgeted income	90	100	120	140
Fixed costs	60	60	60	60
Variable costs	36	40	48	56
Budgeted expenditure	96	100	108	116

**Questions: 60 marks (75 minutes)****Section A (20 marks)**

- 1 What is meant by the term 'cash flow'? (2)
- 2 What is meant by the term 'variable costs'? (2)
- 3 What is meant by the term 'temporary staff'? (2)
- 4 Calculate the total number of meals that Pippa would need to sell in 2012 to break even and, assuming that the burger bar is open 50 weeks a year, the weekly number of meals? (3)
- 5 Based on the figures provided by Pippa in her budget forecast, calculate the percentage sales growth from 2012 to 2015. (3)
- 6 Explain the benefits to the business of using a mix of full-time, part-time and temporary staff. (8)

**Section B (40 marks)**

- 1 Analyse two possible benefits if Relish were to become a private limited company. (10)
- 2 To what extent do you agree with Pippa's decision to set up her own burger bar rather than use an established franchise? (15)
- 3 Is Pippa right to try and finance her new business venture using retained profit and savings rather than seek alternative sources of finance? Justify your view. (15)

**Candidate's response (A grade)****Section A (20 marks)**

1 This is a forecast of the expected money coming into the business, via sales of the burgers in the restaurant, as well as the expected money going out of the business, comprising costs such as ingredients, staff wages and rent.

This is a clear definition, with use of examples directly related to the business. (2 marks)

2 Variable costs are the costs of the business that vary directly with the amount of sales that the business generates. A good example of this would be the ingredients, such as meat, that are used for the burgers. The more sales that Pippa makes, the greater the variable costs.

Again, this is a strong definition and the example relates to the business. (2 marks)

3 Temporary staff are people employed for a fixed period of time. They might be employed on a full-time or part-time basis and will be used for particularly busy periods such as Christmas.

The candidate displays a good understanding of the term. (2 marks)

$$4 \text{ Breakeven} = \frac{\text{Fixed costs}}{\text{Price} - \text{Variable cost per unit}} = \frac{\text{£}60,000}{\text{£}5 - \text{£}2}$$

Annual breakeven in 2012 = 20,000 meals a year

Weekly breakeven in 2012 = 20,000 ÷ 50 = 400 meals

This answer is clearly set out – the formula has been written down and then the numbers have been used correctly.

(3 marks)

5 Sales 2012 = £90,000

Sales 2015 = £140,000

$$\% \text{ sales growth} = \frac{\text{New} - \text{Old}}{\text{Old}} \times 100 = \frac{140,000 - 90,000}{90,000} \times 100$$

% sales growth = 55.56%

The candidate has identified the relevant numbers and accurately calculated the answer. (3 marks)

6 A mix of different types of staff will give the business greater flexibility in terms of meeting demand. The burger bar is likely to have a varying number of customers – it will need more staff during busy periods such as lunch and dinner and also at the weekends. Such a mix of staff will allow it to meet this demand more easily and will mean it can draw on a range of experience. The full-time staff are likely to have a greater knowledge and carry out more duties than the part-time and temporary staff. They will be able to guide, manage and motivate the other staff during the busy periods.

This answer clearly demonstrates application and the requirements of staffing for a restaurant. It is essential that this skill of application is evident in all case study answers. The benefits are then developed and explained in more detail, leading to analysis. (8 marks)

**Section B (40 marks)**

1 The first main benefit would be that Pippa would now have limited liability. This means that only money invested in the business would be at risk if it were to get into financial difficulty. Pippa's personal possessions would be safe. The limited liability means that she would be able to invite people to buy shares in the business and this would be more attractive to potential investors. By acting as a private limited company, Pippa could also look to bring in additional



investors, but only from people that she invites. Given the substantial sum of money needed (£150,000) to get the new venture up and running, this may prove useful and necessary.

The second main benefit would be that the business would have a greater standing. Limited liability would mean that it is likely to be easier to raise finance from institutions such as banks, as well as securing and building up better relationships with potential suppliers. In addition, the records and accounts of the business would need to be published. While it is likely that Pippa and Andy currently have a deed of partnership, a shift of status to a private limited company would require a more formal business agreement and structure. This would prove useful if they were to have any disagreements about the direction of the business.

The candidate shows a really good understanding of the benefits of limited liability and, again, she relates this to the business, using figures from the case study. However, the analysis is not always fully developed into a clear chain of reasoning. (7 marks)

**2** Setting up as her own burger bar will give Pippa greater freedom in designing and putting together her own menu. She will be able to develop her own USP and decide on the logo, pricing and marketing of the business. The ability to have greater control over the decision making within the business will allow her to be her own boss and have a strategy that can be tailor made. This option is also likely to be operationally cheaper, as she will not have to pay a royalty to operate as a franchise. While it is likely that she will have to invest more of her own money in marketing, once again she can decide on how and where she will look to promote the business and she will not be reliant on the national advertising carried out by the franchisor.

Operating as a franchise, however, would clearly have a number of benefits. The main one is that Pippa would be able to operate using an established brand name. This would bring greater recognition for the business among potential customers and prove useful in attracting customers that might be visiting Cirencester. They will be more likely to choose a business that they recognise and this will lead to increased custom and potentially higher sales. It would prove harder for Pippa to attract customers without a franchise.

In conclusion, having already run a successful independent business, I believe that Pippa would prefer to retain control and avoid interference from a franchise holder. The fact that there is not currently a franchise in operation within the town suggests that major franchises may perceive no demand for this type of business. It would appear that Pippa should therefore aim for her own style of burger bar and this would

allow her to differentiate her firm from the existing franchises. One future option that she could investigate, if successful, would be to offer her own style of burger bar as a franchise to other businesses in nearby Cotswold towns.

This is a very strong three-paragraph answer. The candidate displays all the skills required – good understanding of franchises, application of knowledge to the case study, and building of the arguments as to whether or not the business model was correct. Clear judgements are made throughout and also at the end of the answer. The suggestion of something new is absolutely fine, as it shows insight. (15 marks)

**3** The use of retained profit is a good source of finance because it is relatively cheap and does not require any additional interest payments. However, it does carry an opportunity cost – these funds could have been used elsewhere by Pippa and may leave her at risk if the burger business does not prove as successful as hoped. She has worked hard over the years to build up the Relish brand and to put this success at risk might prove costly. The sum of £150,000 is a significant amount and it could be wise to look at alternatives.

If Pippa were to look at alternative sources such as a venture capitalist, she would not only receive financial support but also receive help and guidance on how to operate the business. This could prove very beneficial as the venture capitalist might have greater experience and knowledge of the market, helping her to make the business more of a success. They would also then both have a real interest in helping the business grow, since she would have to offer a percentage stake in the business in return for the investment.

It is likely that Pippa has already built up a good relationship and reputation with her bank after the growth of Relish. The figures for the business are healthy and, while the new venture might be seen as a risk, it is probable that she will be able to receive funding via a bank loan or overdraft if required. Looking at her forecast, this might be necessary during 2012 as she will be making a loss of £6000 in this year. In addition, initial sales may not be as high as forecast, which could result in higher losses. The aim of financing the business using her own funds is a good idea. However, I would suggest that access to an overdraft facility would be important, especially in the early years of trading.

This is another solid response that uses the three-paragraph rule. The middle paragraph shows good analysis of why venture capital might prove beneficial and, though the evaluation is perhaps not as strong, the candidate is clearly trying to answer the question set. (12 marks)