
Chapter 17

Unit 4

Management 2 - Managing business and household finance

Higher Level

Chapter Notes

EXPLAIN WHAT IS BUDGETING

Business and household need to manage their finance and make sure that their cash inflow (Income) meets their cash outflow (Spending)

2017 Short Question 5

Cashflow

Def is the difference between the money flowing in and out of a business or household.

A cashflow forecast (Budget)

Def is a document showing the planned flows of money in and out of a business or household over a certain period of time. It is used to predict the big income and expenditure and when they are likely to occur for a business/household.

HOW DO BUSINESS BUDGET

1. Businesses use a cashflow forecast to predict the amount and timing of income and expenditure and plan how best to use their finances.
2. If money is coming into a business faster than it is going out it has a positive cashflow.
3. This is good because it means the business has enough cash to pay their expenses.
4. But if money is flowing out of a business faster than money is coming in the company will run out of cash and need to borrow
5. This is called negative cashflow. When this happens, they are operating beyond its means. Spending needs to be controlled and cutbacks need to happen.

BENEFITS OF CASHFLOW FORECASTS

1. Assists Financial Planning

2015 Question 6 C
2013 Question 6 C

Cashflow forecast can act as an early warning system of possible cash shortage and/or positive cashflow. It will help a business manage its cash flow *and live within its means*. It acts as a financial *control mechanism* that can be used to measure actual cash flow against planned cash flow encouraging a business *to plan its finances sensibly* and not to overtrade. It can help to avoid cash flow problems and ensure it has sufficient funds.

2. Financial Control

By predicating cash shortages business and households can identify when and where savings/cutbacks need to be made. It will help a business to identify periods of time in the future when the business will have an excess of expenditure over income i.e. a deficit and then **take corrective action to deal with the cash shortfall**

3. Loan Requirements

Cash flow forecast can be used by business to show how much loan finance will be needed to keep the business afloat. This will reassure investors and banks that the business will be well managed. It will help a business gain access to finance from financial institutions as the cash flow forecast is an integral part of the business plan given to banks and other potential investors. It can be used to Supports applications for loans and grants

4. Surplus funds

It will help a business to identify periods of time in the future when the business will have a surplus of income over expenditure. The business can then **make plans** to place these surplus funds on deposit with a financial institution or make expansion decisions.

HOW A BUSINESS CAN OVERCOME A CASHFLOW PROBLEM

1. Decrease its cash outflows

2015 Question 6 C
2013 Question 6 C

This can be done by targeting (discretionary) expenditure and reducing its spending on for example, entertainment and holidays.

2. increase its cash inflows

this can be done by increasing the income levels. This may involve a non-working family member returning to work. It might involve doing overtime to earn extra income or even getting a second job.

3. Arrange a bank overdraft facility

This can be done with the bank to finance problem months where the household is running a deficit. The overdraft facility provides extra flexibility for the household when it needs it

most. However, care should be taken because the rate of interest charged on a bank overdraft is high.

THE ELEMENTS OF AN EFFECTIVE CASH FLOW FORECAST

When reading a cash flow forecast it is important to note the following

1. Is it Realistic?

If in doubt predicted income should be underestimated and predicted expenses should be overestimated? Reserve finance should be available in savings or loans.

2. Are there seasonal factors?

Does the take into account the highs and lows in sales (December V March).

3. Credit

The Cashflow statement should take into account possible delay in payment from debtors and household when starting a new job and receiving their first pay slip.

4. What about bad debts

These are debtors (people who owe the business money) who do not pay their bills. This is money lost to the business.

5. Are taxes included?

WHAT ARE THE MAIN SOURCES OF FINANCE FOR HOUSEHOLDS AND BUSINESSES

The sources of finance available to a business and a household are -

Short term finance is finance available for a period of up to one year. It should be repaid within twelve months and should be used for short term needs.

Medium term Should be repaid within one to five years.

Long Term Does not need to be repaid for at least 5 years.

HOW SHOULD A SOURCE OF FINANCE BE SELECTED

The following criteria should be taken in consideration when selecting a source of finance -

2017 Question 5 C

1. Purpose

The source of finance should match the use for which it is needed. The reason for the finance must be considered. Is the finance required for the day-to-day running of the business or to finance business expansion? Short term needs must be financed from short term sources (e.g. Acquiring stock may choose bank overdraft or trade credit). Long term needs require long term sources of finance (equity, debentures).

2. Amount

The source of finance should be able to provide the amount of finance required. If large amounts are required generally a long-term source of finance is chosen as you can spread the costs over a longer period of time.

3. Cost

Both should try to get the cheapest source of finance. APR (Annual Percentage Rate) is a standard measure of the interest charged on loans. Some sources of finance are tax deductible. Debt finance is costly as monthly repayments must be made, while equity finance and retained earnings avoid costly monthly payments.

4. Control

Different sources of finance could impact on ownership and control in a business. Issuing more shares could spread ownership and control to more people. Additional shareholders will have a say in the business and an entitlement to future dividends.

5. Risk

Every source of debt finance involves risk, and the business must do a risk analysis in advance to assess the level of risk for the business.

SHORT TERM SOURCES OF FINANCE

1. Trade Credit and Credit Purchases (Business)

Trade credit ^{Def} means receiving goods from suppliers now but paying for them later. The amount of credit available may be dependent on the reputation and creditworthiness of the business. It can be used to purchase raw material for resale.

2019 Question 5 (C)
2018 Short Question 4
2014 Question 6 (B)
2011 Short Question 9

This will give the business time to sell the stock before paying for it. The new business will have to negotiate terms with its suppliers. To receive prompt payment suppliers usually offer discounts to business and charge interest for late payments.

<u>The amount</u>	available from trade credit may vary on the size of the purchases.
<u>Cost</u>	Using Trade credit can mean losing out on discounts and a firm may be given a poor credit rating if they are late paying their debts.
<u>Control</u>	No security is required but suppliers can retain ownership to the goods until payment is made.
<u>Risk</u>	Low risk but a business reputation may be damaged with suppliers if it is too slow paying its bills.

Example Paying for Stock (Business)

2. Accrued Expenses (Business and Household)

Accrued Expenses ^{Def} This is also known as unpaid expenses. It means delaying payment of bills and using the money to pay more urgent expenses. This source of finance frees up money by delaying the payment of regular bills such as utilities, rent or insurance

Businesses and households can delay paying bills (Gas, Electricity) until absolutely necessary and use this money to pay other bills. Households have to be careful that they do not delay too much else they may be cut off until the bills are paid.

<u>The Amount</u>	Relatively small.
<u>Cost</u>	No interest is paid but business and household may lose out on discount for prompt payment.
<u>Control</u>	Security is not required and control is not affected.
<u>Risk</u>	A business or household may get a bad reputation for not paying debts or settling debts on time.

Example Paying of Utilities (Light and Heat) (Business and Household)

3. Bank overdrafts

Bank overdraft ^{Def} This is a facility offered by a bank that allows current account holders to withdraw more money from their account than they actually have in it. It is up to a certain limit. Interest is charged on the outstanding balance on a daily basis. It can be recalled by the bank at any time.

<u>Amount</u>	Varies according to the assets or cash flow of the household.
<u>Cost</u>	Interest is charged on a daily basis on the amount borrowed with rates depending on the credit rating of the household or business. A fee may also be charged.
<u>Control</u>	Often security is not required.
<u>Risk</u>	The bank can demand payment at any time.

Example Paying wages (Business)
 Paying for groceries (Household)

4. Credit Cards (Business and Household)

Credit Cards ^{Def} This is when you pay for goods at the counter using a credit card. The credit card company pays for the goods and then the buyer pays back the credit card company with interest within an agreed period of time

<u>Amount</u>	Varies according to the assets or cash flow of the household.
<u>Cost</u>	Interest is charged at a high rate if the balance is not paid off.
<u>Control</u>	Security is not required.
<u>Risk</u>	Damage to credit rating if the debt is not repaid.

Example	Paying wages (Business)
	Paying for groceries (Household)

5. Factoring Debt (Business)

Factoring ^{Def} This means selling the right to collect payment from your debtors to a factoring (Debt collecting) firm.

<u>Amount</u>	Depending on the size of your debtors' large sums of finance can be raised quickly.
<u>Cost</u>	Factoring can be expensive as a factoring firm will only pay a percentage of the full debt.
<u>Control</u>	No loss of control of the business.
<u>Risk</u>	A firm that is seen as factoring their debts may be seen as desperate for cash so can damage its reputation.

Example	For gathering debts (Business)
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MEDIUM SOURCES OF FINANCE

1. Hire Purchase

Hire Purchases ^{Def} This allows a household or business to buy an asset (car) by paying for it in instalments over a period of time. Usually between 1-5 years. The asset can be used straight away but full ownership only passes when the item is paid for in full (last instalment)

2019 Question 5 (C)
2018 Short Question 4

<u>Amount</u>	Expensive equipment (Vans)
<u>Cost</u>	The final overall cost of the asset will be higher than if cash was given. however, business can offset it against tax.

Control No security is given but the asset can't be used a security for any loans until it is fully paid for.

Risk By the time the asset is paid for it may have become absolute or depreciated in value.

Example Buying delivery Vans (Business)
Buying cars (Household)

2. Leasing

Leasing ^{Def} This means renting an item (Car) for an agreed number of years - usually between 1-5 years. When the lease is up the item is returned to the lessor. The business will never get to own the asset.

Amount Expensive assets can be acquired quickly for use by the household/business.

Cost Leasing costs more than cash purchases but cash flow is improved as money is not tied up in an asset. businesses can offset this against tax

Control security is required as the leasing company retains ownership of the asset. The household and business must sign a contract agreeing to lease the assets for a number of years.

Risk Since you don't own the asset you don't have to worry about the asset becoming absolute or depreciated in value.

Example Leasing a building (Business)
Leasing a house (Household)

3. Term Loans

Term Loan ^{Def} This is a loan from a financial institution that is repaid in monthly installments over a period of 5 years. The condition of the loan differs on the needs of the household or business (Duration, interest charged, security required.) For reliable household and business term loans are easy to negotiate.

<u>Amount</u> -	Large amount of finance can be borrowed.
<u>Cost</u> -	Interest paid is usually lower than overdrafts. The better the borrower's credit status, the lower the risk to the lender thus lower interest rates
<u>Control</u> -	Banks may look for some asset to be used as security (Collateral) in the event of a non-repayment. The bank may also seek a personal guarantee
<u>Risk</u> -	Failure to repay can damage a firm's credit rating and reputation but the duration of the loan can be customized to suit the needs of the individual.

Example	Buying machinery (Business)
	Buying a kitchen (Household)

LONG TERM SOURCE OF FINANCE

1. Mortgages

Mortgage	Def These are loans used to finance the purchases of a house or other property. They are available from a bank or building society. A household/business will have to calculate the implication of the monthly repayments on their monthly cash flow before applying for a mortgage.
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<u>Amount</u>	Large amounts of finance can be borrowed.
<u>Cost</u>	The rate of interest charged will depend on the borrowers' credit rating. The lower the risk to the lender the lower the rate
<u>Control</u>	The security for the loan will usually be the deeds of the house.
<u>Risk</u>	Failure to pay can result in repossession of the property but the loan can be customised to suit the borrowers needs.

Example	Purchase a house (Household)
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2019 Question 5 (C)
2018 Short Question 4

2. Savings/Retained earnings.

Savings	Def are a major source of finance for a household (Banks. Credit unions, An Post). Deposit accounts pay savers interest on the money saved. The rate of interest will depend on the amount saved and how long it has been
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left on deposit. Retained earnings (reserves) a profit that have been retained (put back into the business) to allow the business to expand.

<u>Amounts</u>	can be large if the firm retained large amounts of profits.
<u>Costs</u>	No cost involved.
<u>Control</u>	No loss of control.
<u>Risk</u>	No risk.

Example	House extension (Household) Pay off loan (Business)
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3. Owner's Capital/Equity (Business)

Owner's Capital	^{Def} This is finance brought into a business by the owner. This finance can be brought into the business through the entrepreneur's personal finance, selling shares or bringing in a new partner.
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<u>Amount</u>	Personal savings are not enough to finance a business but it shows investor that you believe in the company
<u>Cost</u>	If no profits are made then no interests or dividends have to pay to shareholders but if the business is successful then shareholder are paid.
<u>Control</u>	Will have to be shared if new partners or shareholder buy in
<u>Risk</u>	No risk but if the business fails the money may also be lost.

Example	Purchase a new building (Business)
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4. State grant

Grants	^{Def} This is a free gift of money provided to a business to be used for a specific purpose. There are no interest or cash payments involved but there are conditions that must be met and if they are not, the money will have to be paid back.
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<u>Amount</u>	Depending on the purpose grants can be quite large.
<u>Cost</u>	There are no interest charges or dividend payments.

<u>Control</u>	There are strict rules on what the money can be used for.
<u>Risk</u>	There is little risk but if conditions are broken the grant is reclaimed.

Example business startup (Business)

5. Debentures/Long term loans (Business)

Debentures ^{Def} are long-term fixed interest loans secured on a valuable asset such as a premises. The company must repay the interest each year regardless of if they make a profit or not. The full loan must also be repaid in full at a future date.

<u>Amount</u>	Very large sums are available.
<u>Cost</u>	A fixed amount must be paid annually over the life of the debenture which can be very expensive.
<u>Control</u>	Security is usually required.
<u>Risk</u>	In the event of non-repayment the asset used as security can be sized.

Example Purchase a new premises (Business)

6. Sale and lease back (Business)

Sale and Lease Back ^{Def} This is a contract to raise cash by selling a piece of property and then leasing it back on a long-term lease. This provides the business with a lump sum of money.

<u>Amount</u>	Depending on the value of the asset, large sums of money can be raised.
<u>Cost</u>	is the cost of the lease.
<u>Control</u>	The business loses ownership and control of the asset.
<u>Risk</u>	No risk to the business.

e.g Eircom raised 180m from the sale and leaseback of its head office, the buyer agreed to lease the building back to Eircom for 8m per year.

Example Purchase machinery (Business)

7. Venture Capital (Business)

Venture Capital ^{Def} These are people (or organisation) who invest their money into business who have a potential for high growth/return. For this investment they get a share in the business and will sell the share back when the business is successful. They also give their expertise to help the business.

Amount Depending on the company.

Cost profit are shared

Control The business gives away a stake in the business.

Risk

e.g Eircom raised 180m from the sale and leaseback of its head office, the buyer agreed to lease the building back to Eircom for 8m per year.

Example Business Expansion (Business)

WHAT A BANK LOOKS FOR BEFORE GIVING A LOAN

2020 Question 6 (A)
2014 Question 6 (B)

1. Amount and purpose of a loan

- Amount - The larger the amount and the longer the duration of the loan the riskier it is for the bank. As a consequence, the loan application may be affected. It will be expected that the loan application is for a productive purpose e.g. business expansion.
- Purpose - The more productive and low risk the greater the likelihood of getting approval.

2. Character and creditworthiness of applicant

- Name address and occupation - of the applicant and/or nature of the business
- Good character/reputation - for an individual they will want to know how long you have been in your job for and living at your address for a business they might want to know who owns it and how long it has been running.

- Creditworthiness - An applicant with a good banking history will be viewed more favorably by the bank. This means looking at repayment of previous loans. Any bad debt history will affect the loan application.

3. Capacity of applicant to repay

- Ability to repay pay - they will look for evidence for the applicant to repay the loan. An Individual- P60 and the business a copy of their accounts
- Business Plan - This needs to be prepared in advance to reassure the bank that the money is going to be used wisely. A business plan will outline the trading history and predicted profit trends for the business

4. Collateral available

- Security (Collateral) - the greater the value of the security, the lower the risk for the bank. A valuable asset such as premises will be required as collateral for the loan. In the event of a default the bank will be able to sell the asset to recover its loan.

HOW CAN CURRENT ACCOUNTS ASSIST BUSINESS AND HOUSEHOLD FINANCIAL MANAGEMENT

1. Pay-path system

1. This is used for paying wages directly into an employee's current account.
2. It's safer and more convenient than being paid by cheque or cash.

2. Cheques books

1. Allows payment to be made by using cheques.
2. These are notes to a bank asking them to pay money from your account to a person whose name is written on the cheque.

3. Stranding orders

1. These are arrangements with the bank to pay a fixed amount out of your bank account at regular interval to someone else's account.
2. They are useful for regular payments such as car loan repayment.

4. Direct Debits

1. These are arrangements with the bank to pay varying amounts at regular intervals to someone else's account.
2. They are used to pay light and heat and mobile bills

5. ATM cards

1. These allow the card holder to use ATM machines to access bank services such as cash withdrawals, lodgments, bill payments or to order a new cheque book or bank statements.

6. Debit Cards

1. These are also known as laser cards.
2. They allow the card holder's account to be debited (deducted) by the bank every time the card is used to purchase something. (Cashless Society)

DIFFERENCE BETWEEN BUSINESS AND HOUSEHOLD FINANCES

Differences

Financial Planning	This is more detailed for a business when applying for a loan. They will be financial statements such as Profit and loss account balance sheet and a cashflow forecast. These is to show that they have the ability to repay the loan
Amount borrowed	Business tend to borrow larger amount than households. Which tend to be for the purchase of machinery and premises. There are more expensive than household needs
Taxes	Business can claim the taxes they have paid against their profits. This will reduce the tax they have to pay and the amount of corporation tax paid
Sources of Finance	There are more source of finance available to a business than a household. For example factoring and trade credit

Chapter 4

Managing business and household finance

Higher Level

Past Exam questions (For this chapter)

SHORT QUESTIONS

2018 - Question 4

Column 1 is a list of finance terms. Column 2 is a list of possible explanations for these terms.

(One explanation does not refer to any of these finance terms)

Column 1 - Terms		Column 2 - explanations	
1	Leasing	A	A facility on a current account that allows you to access funds to an agreed limit above your actual balance
2	Hire Purchases	B	A financial contribution given by an organisation for a specific purpose provided certain conditions have been met
3	Overdraft	C	Selling a trade debt to a third party at a discount
4	Grant	D	Purchasing an asset by instalment over time
5	Trade credit	E	Renting an asset but never owning it
		F	Receiving goods from a supplier and paying for them later

Match the list by placing the letter of the correct explanation under the relevant number below

1	2	3	4	5

2017 - Question 5

Study the cashflow forecast below and fill in the figures represented by the letters A,B,C,D and E

Cashflow forecast for Intenso Ltd, for the 3 rd quarter of 2017				
	July (€)	August (€)	September (€)	Total (€)
Total Receipts	20,000	A =	12,000	57,000
Total Payments	14,000	17,000	15,000	46,000
Net Cash	6,000	8,000	B =	C =
Opening Cash	5,000	11,000	19,000	D =
Closing Cash	11,000	19,000	16,000	E =

2011 - Question 9

(a) Explain the term short term finance

(b) Illustrate a business situation where short term finance would be appropriate

LONG QUESTIONS**2020 - Question 6**

Read the information supplied and answer the questions that follow

Gym Culture

Dan used a bank loan to finance the setting up of a gym near a local university in 2010. He wanted to offer a no contract, pay as you go train option to students while also offering personal programmes. In 2018 he opened two new gyms he hired five full time staff and now offers classes aimed at men and women who are parents of new babies. Dan believes employees empowerment has been the key to his success

- (A) Outline the factors Dan's bank would consider before granting a loan application (15)

2019 - Question 5

- (C) Describe two distinct situations requiring short term finance for a startup business and explain the most appropriate source of short-term finance in each situation (20)

2017 - Question 7

- (C) Discuss the factors a business should consider when choosing a source of finance (20)

2015 - Question 6

- (C) The cash flow for Amrod Ltd for the final quarter of 2015 is set out below

Cash flow forecast for Amrod Ltd for the 4th quarter 2015				
2015	October	November	December	Total
Total Receipts	70,000	180,000	90,000	340,000
Total payments	100,000	165,000	120,000	385,000
Net Cash	(30,000)	15,000	B	(45,000)
Opening Cash	20,000	A	5,000	C
Closing Cash	(10,000)	5,000	(25,000)	(25,000)

- (i) Explain the reason Amrod Ltd would prepare a cashflow forecast
- (ii) Calculate the figures represented by the letters A, B and C on the cashflow forecast
(Show your workings in your answer book)
- (iii) Explain how Amrod Ltd might deal with the financial problem identified in this cashflow forecast (20)

2014 - Question 6

Sarah Fleming is a wedding dress designer and has worked for over 20 years in the bridal and clothing industry. She specialise in creating unique wedding dresses with an emphasis on personal service. Business is good and Sarah has applied for a bank loan of €10,000 to finance expansion

- (B) Outline three factors Sarah's bank may consider when assessing her bank loan application (15)
- (C) (i) Explain the term short term finance
- (ii) Outline tow sources of short term finance Sarah may consider to meet her working capital needs (20)

2013 - Question 5

- (C) (i) Outline two reasons why a household should prepare a cashflow forecast
- (ii) Illustrate how a household can overcome cashflow problems (20)

2012 - ABQ

- (A) Identify and describe the most appropriate source of finance to meet the needs of
- (i) RIM Ltd
- (ii) Individual stallholders (20)