Erasmus+

Welcome to Chapter 4

Understanding Sales and Finances

BGame
Strategic Management Virtual Game for SMEs

Welcome to the BGame Training Course!
We are delighted to have you here, with us, today!

In this training course there are 5 chapters: Strategic Management, Internationalisation, Human Resources, Sales and Finances and finally, Marketing and Advertisement. In this course, you are free to explore these chapters as you please. They are intended to provide you with a simple overview of each area in which you will have to take decisions while playing our Virtual Game.

These resources are part of BGame Virtual Game and have been prepared by a partnership of seven institutions expert in education and training. Should you wish to obtain any further information about BGame project, please do not hesitate to contact us on www.bgame-project.eu

We hope you enjoy!

BGame Partners

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Virtual Game for SMEs

Content of this Chapter:

1. What is the logic behind a sales process?
2. How can the BMC be a tool to build a logic of the business and a foundation for launching a process of sales?
3. What are the marketing concepts related to a sale process?
4. What is the connection between the sales process and the financial analysis?

Goals of this Chapter

You will be able to …

- Systemize the process behind selling a product.
- Use the model canvas (BMC) to build a logic of the business and a foundation for launching a process of sales
- Understand the relationship between sales and financial analysis.

An introduction to Sales and Marketing

- **Sales** are an essential process in a company. Without it, a company cannot generate revenue, and thus also cover the cost of doing business, cannot invest and ultimately stay on the market.

- For a company to be successful, three elements have to come together: **a product** or **service** sold by the company, **a customer** who is willing and able to buy, and **a market** on which the product or service is going to be offered.

- The fact that there are customers who can potentially buy the product is not sufficient to be successful. A company has to convince a large number of customers that it offers products that distinguish positively from those offered by competitors.

An introduction to Sales and Marketing

- A variety of **marketing tools** can be used in this process. Once the product has been sold, one needs to keep the customer satisfied, otherwise he/she will never come back and will not encourage others to buy products.

- **Sales** are not an single event but a process that has its origin in the decision of a merchant to sell a specific product in a particular market. As a process it has stages and a logic.

- When thinking about business one needs to systemize the process and build a coherent and logic system that stands behind the process of selling a product.

An introduction to Sales and Marketing

- In this section, we will present a concept of business model canvas (BMC), a tool that is used to build a logic of the business and a foundation for launching a process of sales.
- We will then analyse the sales process alongside with marketing concepts and some advice on how to attract customers and create customer relationships. The success of the sales process can be considered via financial result.
- In the second part of the chapter some basic issues of finance and financial analysis will be presented to deliver some insights what is important as far as finances of the company are concerned.

An introduction to Sales and Marketing

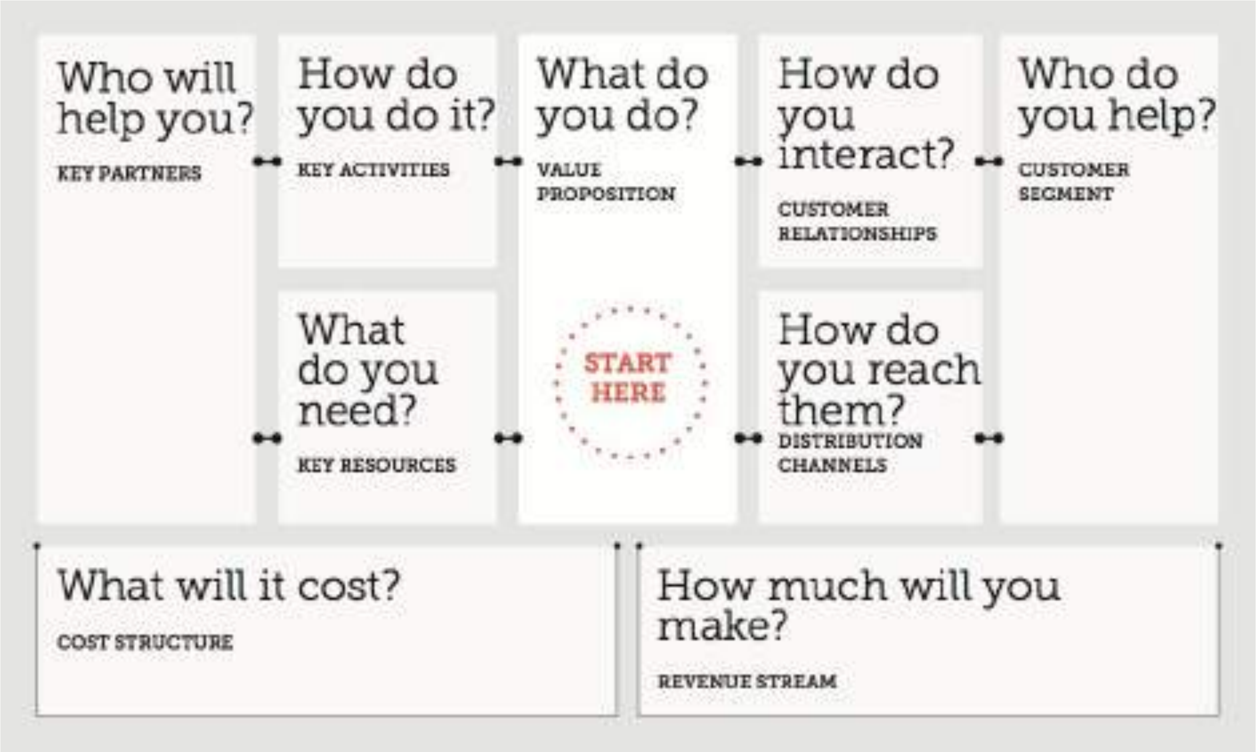
- The **Business Model Canvas – BMC –** is a tool used by a lot of entrepreneurs worldwide. It enables them to describe, design, challenge and pivot a business model.

- The BMC describes how nine components of a business model fit together.

- It is a powerful technique for painting pictures of how organisations work, it provides a visual shorthand for simplifying complex organisations.

The Business Model Canvas was introduced by Alexander Osterwalder!

An introduction to Sales and Marketing



Source: www.diytoolkit.org

Costumer segments

Customers are the reason for an organisation's existence.
No organisation survives long without paying customers.

The company needs to answer the following questions:

- Who is our customer?
- For whom do we create value in the company?
- Does our company operate in a niche market or mass?
- On what segments can our clients be divided taking into account their concerns and expectations?
- How do we share our clients and what strategies do we use?

Costumer segments

- Since no company can serve all **costumers**, the market requires segmentation.
- **Customer Segmentation** is the subdivision of a market into discrete customer groups that share similar characteristics [Rigby, 2015].
- By dividing customers into groups, managers can prioritize new product development efforts, develop customized marketing programs, choose or emphasize specific product features, establish appropriate service options, design an optimal distribution strategy or determine appropriate product pricing.

Costumer segments

- Divide the market into meaningful and measurable segments according to customers' needs, their past behaviours or their demographic profiles.
- Determine the profit potential of each segment by analysing the revenue and cost impacts of serving each segment.
- Target segments according to their profit potential and the company's ability to serve them in a proprietary way.
- Invest resources to tailor product, service, marketing and distribution programs to match the needs of each target segment.
- Measure performance of each segment and adjust the segmentation approach over time.

Customer Segmentation has some requirements to managers.

Costumer segments

Each product has specific attributes.

Customers have different interests, tastes or preferences so the product has to be customized, tailored to the specific market.

The customer segmentation seems to be indispensable.

Value Proposition

As far as sales are concerned, the **value proposition** is the foundation for good sales prospects. Having a really good value proposition it becomes much easier and more effective to sell a product.

The **value** can be seen in:

- Convenience (e.g. more functionalities - smartphone);
- Price (e.g. in general cheaper) or design (e.g. modern);
- Brand or status (e.g. bags from Louis Vuitton);
- Cost reduction (e.g. equipment A+++ class with lower demand for energy);
- Quality; and,
- Reliability.

Value Proposition

Evaluating current value proposition is possible by checking whether it answers the questions below:

- What product or service is the company selling?
- What is the end-benefit of using it?
- Who is the target customer for product or service?
- What makes the company offering unique and different?

Value Proposition

While building the value proposition it is recommended to use the following template:

- **For** - specifically describe target customers,
- **Who** – statement of need or opportunity,
- **The** (product name) is a – product category,
- **That** – statement or key benefit/ that is compelling reason to buy,
- **Unlike** – competitors or primary competitive alternative.

Value Proposition

Is a key message to your customers why they should buy your product.

It is critical for the business model, thus for the sales and expected revenues.

Make an effort to construct it in a concrete, comprehensive and attractive way. .

Channels

- A company can deliver its value proposition to its targeted customers through different **channels**.

- Effective **channels** will distribute a company's value proposition in fast, efficient and cost effective ways.

- An organisation can reach its clients either through its **own channels** (store front), **partner channels** (major distributors), or a **combination of both**.

Channels

Channels perform **5** functions:

1. **Awareness** - Create awareness of services or products.
2. **Evaluation** - Help potential Customers evaluate products or services.
3. **Purchase** - Enable Customers to purchase.
4. **Delivery** - Deliver Value to Customers.
5. **After Sales Follow-up** - Ensure post-purchase satisfaction through support.

Channels

While constructing channels in your business remember that you need to:

- evaluate the value proposition
- attract customers
- enable them purchasing
- deliver them the product
- keep them satisfied

Costumer Relationships

- **Customer relationship management – CRM -** is a term that refers to practices, strategies and technologies that companies use to manage and analyze customer interactions and data throughout the customer lifecycle.
- **CRM goal** is improving business relationships with customers, assisting in customer retention and driving sales growth.
- **CRM systems** are designed to compile information on customers across different channels -- or points of contact between the customer and the company which could include the company's website, telephone, live chat, direct mail, marketing materials and social media.

Costumer Relationships

CRM give customer-facing staff detailed information on customer's:

purchase history;

personal information;

concerns.

Key resources

- **Key resources** are the main inputs that a company uses to create its value proposition, service its customer segment and deliver the product to the customer.

- As far as sales are concerned, typical resources include:

  - sales offices facilities (offices, internet centres),
  - sales personnel,
  - financial resources used to organize and run sales office or centres, network, customer relationship management systems.

Key resources

There are **4** main types of resources:

1. **Physical resources:** equipment, inventory, buildings, manufacturing facilities, vehicles, machines, systems, point-of-sales systems, distribution networks.

2. **Intellectual resources:** intangible resources like brand, patents, IP, copyrights, partnerships, customer databases.

3. **Human resources:** all employees that company hires.

4. **Financial resources:** cash, lines of credits, stock options pool for hiring key employees.

Key resources

Evaluate each of your key resources to find out whether the given resource is essential to the success of the business or not.

Key activities

- There are different **kinds of activities** which include:
    - production,
    - distribution,
    - sales,
    - research and development,
    - networking,
    - marketing, etc.

Key activities

- As far as sales and customer services are concerned, activities include:
  - setting sales offices,
  - hiring salesman,
  - product packaging,
  - setting price mechanism together with discounting policy,
  - customer acquiring,
  - CRM, etc.

Key activities

- **Key activities** have to be founded on the value propositions – it determines range and variety of activities the company performs.
- Distributions channels are other important factor determining **key activities.**
- **Key activities** have to be bind with customer relationships – company needs to attract customers and then keep them satisfied.
- **Key activities** are crucial to generate revenue streams – only having revenuers company can survive.

Key activities

Plan sales and customer services carefully to build a large cohort of customers, that are loyal and may become your advocates in the market.

Key partners

- The contemporary world is more and more interrelated.
- Networking and building partnership is not only the strategy to increase effectiveness of business performance, but also a condition for surviving on the market.

Here are the main reasons for which companies cooperate:

Key partners

- **Optimization of costs and economies of scale:** having joint sales office can bring cost reduction, and economies of scale especially when products are complimentary.
- **Reducing the risk:** entering new markets always increases risk of the company so combining efforts with a business partner reduces risk, especially when the partner knows the market very well.
- **The acquisition of resources or activities:** acquiring local sales office together with the know-how of its employees.

Key partners

Sometimes it is cheaper to establish partnership with a partner from local market, than try to organise and run sales from the country of origin.

Revenue Streams

Revenue streams are the way a company makes income from each customer segment. The company has to consider three following aspects:

- What value are customers willing to pay?
- What and how do they recently pay?
- How would they prefer to pay?
- How much does every revenue stream contribute to the overall revenues?

Revenue Streams

Some types of revenues:

- Outright sale
- Lease or rent
- Service or usage fee
- Subscription fees
- Licencing
- Brokerage (matching) fees.

Revenue Streams

- It is not just enough to list the sources for various **revenue streams** but equally important to specify their pricing and projected lifecycles too.
- The given **revenue streams** has to be worth to opt for it.
- If the cost of the preparation of the product is higher than the expected revenue received from the customer, it is better to close the specific product cycle or establish another pricing mechanism.

Revenue Streams

Set a right price policy.

- If you set too higher prices, just a few customers will buy the product.

You can use several tools to model the optimal pricing mechanism.

- Including not only the price, but also possible deductions and discounts.

Cost Structure

- Acquiring **key resources**, performing **key activities**, and working with **key partnerships** all incur costs.
- Many start-ups fail in first years just because they are focusing on the product and revenues and they forget to monitor and evaluate costs.

Cost Structure

The following questions have to be considered when constructing a business model:

- What are the main costs that result from the business model?
- Which activities and resources represent the most expensive costs?
- Which part of the costs is fixed in the nature (independent from the scale) and which is variable in nature?

Cost Structure

- **Fixed costs** – remain the same regardless of the volume of the product produced.
- **Variable costs** – refer directly to the volume of the production and rise proportionally with this volume.
- **OPEX: operational expenditures** – associated with the day to day running the company (energy and materials, depreciation (accounting cost), services, local taxes, salaries and social charges, other costs).
- **CAPEX: capital expenditures** – investments in assets of the company.

Cost Structure

Always pay attention to cost structure and changes over the time. Focusing only on the product and revenues can be a treacherous road.

The Business Model Canvas (BMC)

- Modelling the business while using **BMC** can be very effective and enables to understand the logic that stand behind every business.
- Having this we can understand more deeply all processes that are reflected in the business activity.
- Sales is one of the this processes.
- Without the whole business system, sales cannot be effective!

Sales and Marketing Techniques

- businesses owners and managers struggle with how to implement **effective sales and marketing techniques.**

- While there is no one-size-fits-all solution to implementing effective sales and marketing techniques, you can take a **number of steps** as a business owner or manager to help the company meet its goals and objectives.

TIP 1

Identify and promote the unique selling proposition

- You may sell the same or a similar product or service as your competition, so you have to determine why customers should do business with your company instead of your competitors.

- What differentiates your business from another is he unique selling proposition, showing customers the special benefits they receive from doing business with you.

TIP 2

Encourage customers to become a cheering squad for your business.

- Gather testimonials from customers, and use these testimonials in your sales and marketing literature.
- Place video and text testimonials on your company website.
- Print the testimonials in your brochures; and include testimonials in your e-newsletters.
- Social media networks can bring current and potential customers together to create a cheerleading squad to promote your business.
- Prospective customers tend to believe what their peers say about a company more than what the company says about its own products and services.

TIP 3

Ensure that all of your marketing and sales efforts include a call to action.

- A call to action is a statement that tells prospects and customers what they need to do next.
- Never leave it to chance that customers know what they should do next. Decide what you want them to do, and then tell them.

TIP 4
Emphasize benefits instead of features.

- Many companies make the mistake of promoting the features of a product or service, instead of how the product or service benefits the customers.
- Customers tend to be egocentric, so they are interested in knowing what’s in it for them.
- Tell them how your product or service benefits them, rather than focus on how it benefits you.
- Always include these benefits in your marketing and sales information.

TIP 5
Add an irresistible offer.

- Give customers a reason to respond to your sales and marketing techniques by making them an offer they simply cannot refuse.
- An irresistible offer may include a free gift, a discount or bonus items.

Sales techniques

- Each **sales technique** shall be adjusted to the nature of the customer, the sales localisation and run in a systemic way.
- There are many different techniques, always used to build a strong relation with the customer with the final goal to make the customer purchase the product.

Some advice on how to increase the effectiveness of sales:

Sales techniques

- **Marketing your products continuously** – even really good product requires promotion, the more intensive the competitors are and the more standardised the product is, the company has to invest more in product promotion,
- **Run a Customer Reward Program** – people like to be appreciated for frequent buying a product,
- **Give our frees samples** – it is good way to advertise a product and build customer loyalty,
- **Take care about quality and appearance** – it is important that people like the product look, but quality is always s the king,

Some advice on how to increase the effectiveness of sales:

Sales techniques

- **Motivate salespeople** – good motivated salespeople will be more eager to increase the effort to sell more.
- **Keep customers satisfied** – listen carefully to what customers say, gather opinions and data, evaluate and react to negative ones.
- **Be professional in every aspect of the activity** – people like and appreciate professionalism.
- **Provide high quality after sales service** – purchasing the product is a first step of a long-run partnership between a company and the customer.

Sales techniques

The customer doesn’t buy a product, but product attributes.

It is not important what the product is, but what can we do once we have it.

While constituting a value proposition it is good to indicate what kind of benefit the customer gets.

How to write the sales plan?

- Planning the sales in the company is always a part of the marketing plan.

- People responsible for the sales in the company shall always create **sales plans** so they could make relational sales dictions, offer good products to the right customers segments.

One should start with following activities:

- **Refer to the value proposition** that has been planned in a business model – it is always starting point – one needs to know exactly what kind of product the company offers,

How to write the sales plan?

- **Describe your customer's profile** having in mind the value proposition. Certainly, there will be a need to divide customers into groups (segments).

- **Analyse the market** – try to position the product in relation to the competitors while comparing at least the quality and the price.

- **Analyse your price policy and cost structure** – knowing competitors' prices enables the setting of a good price mechanism along with a discounting policy and adjusting prices to particular segments of customers. Cost structure is also important since the price is always derivative of costs and margin of the company

How to write the sales plan?

- **Set short-run and long-run sales goals** – forecast rarely come true, but they always are a basis for planning; preparing predictions for sales it is advisable to refer to historical sales,
- **Identify optimal localisation for products** – important is demand for product at the particular area, but also costs that are connected with specific localisation,
- **Identify own marketing approach and policy** – way and intensity of promotion are important factor for this stage,
- **Identify optimal sales techniques and methods** to be used in the process.
- **Plan the exact system of monitoring and evaluation.**

How to write the sales plan?

Sales are always a interrelation between value proposition (benefits that customer gets while purchasing the product), customer expectation, intensity of rivalry and motivation of the sales personnel.

Marketing and Advertisement

- **Marketing** is everything a company does to acquire customers and maintain a relationship with them.

- It is based on thinking about business in terms of customer needs and their satisfaction. It is less about getting customers to pay for the product, as it does developing a demand for that product and fulfilling the customer’s needs.

- **Marketing** is a very broad topic, that has many concepts, techniques, methods and theories.

- The most known are **4P** and **7P concept of marketing mix**. Organisations always tend to use marketing mix to deploy their marketing strategy as effectively as possible.

The 4 P’s

- In the 1960s, the American marketer, E. Jerome McCarthy, provided a framework by means of the marketing mix = 4 Ps (McCarthy 1975).
- **Product** – the product should fit the task consumers want it for, it should work and it should be what the consumers are expecting to get,
- **Place** – The product should be available from where your target consumer finds it easiest to shop. This may be High Street, Mail Order or the more current option via e-commerce or an online shop,

The 4 P’s

- **Price** – The Product should always be seen as representing good value for money. This does not necessarily mean it should be the cheapest available; one of the main tenets of the marketing concept is that customers are usually happy to pay a little more for something that works really well for them.

- **Promotion** – Advertising, PR, Sales Promotion, Personal Selling and, in more recent times, Social Media are all key communication tools for an organisation.

- These tools should be used to put across the organisation’s message to the correct audiences in the manner they would most like to hear, whether it be informative or appealing to their emotions.

The 4 P's

- The concept has been criticized as it has not been focused on the B2B enough. It also used to fail when it came to service provision.
- In 1981 the concept has been extended to **7P's** (Booms &Bittner, 1981), which enabled to use the concept in service companies and knowledge intensive environments.
- The 3 P's that were added were people, processes and physical evidence, and we will see each one in detail in the next slide!

The 7 P's

The 7 P's

- **People** – All companies are reliant on the people who run them from front line Sales staff to the Managing Director. Having the right people is essential because they are as much a part of your business offering as the products/services you are offering,

- **Processes** –The delivery of service is usually done with the customer present so how the service is delivered is once again part of what the consumer is paying for.

- **Physical Evidence** – Almost all services include some physical elements even if the bulk of what the consumer is paying for is intangible. Even if the material is not physically printed they are still receiving a “physical product” by this definition.

The 7 P’s

Though in place since the 1980’s the **7 P’s** are still widely taught due to their fundamental logic being sound in the marketing environment and marketers’ abilities to adapt the Marketing Mix to include changes in communications such as social media, updates in the places which you can sell a product/service or customers expectations in a constantly changing commercial environment.

The 8th P

- **Productivity and Quality:** This came from the old Services Marketing Mix and is folded in to the Extended Marketing Mix by some marketers so what does it mean?

- This P asks "is what you're offering your customer a good deal?" This is less about you as a business improving your own productivity for cost management, and more about how your company passes this onto its customers.

- Even after 31 years (or 54 in the case of the original P's) the Marketing Mix is still very much applicable to a marketer's day to day work. A good marketer will learn to adapt the theory to fit with not only modern times but their individual business model.

Marketing & Sales: The difference!

- Many at the top management use «Marketing & Sales» as synonyms, even though there is a substantial difference between both.
- A successful management team must understand the differences between «Sales» & «Marketing».
- «Sales» and «Marketing» bring different orientations to the business; hence we are expected to follow different kind of strategies for business success.

Marketing & Sales: The difference!

- **Sales** have a product focus and are mostly production driven;
- **Sales** are only a smaller part of Marketing and have their short-term goals of attaining certain levels of revenue, profit or market share;
- It emphasizes on price variation to close a sale where the objective is to sell the product to the costumer;
- It has a short-term focus and that does not augur well for prudential planning and brand building;
- **Sales** do not attempt to develop strategies for generating long-term competitive advantage.

Marketing & Sales: The difference!

- The sales activity ends with maximizing profits through its maximization;
- When the entire focus is on **sales**, the management expects to start selling the product immediately as the production schedule is complete and the task of the sales department is to sell whatever the production department has manufactured;
- Hence the aggression in **sales** follows to meet this goal. Needs of the costumer and satisfaction levels on the costumer are taken for granted;
- **Sales** do not convert the product into cash for the company in the short run.

Marketing & Sales: The difference!

- **Marketing** is dynamic in nature and has a wider approach than sales;
- **Marketing** focuses on the costumer rather than the product. Sales revolves around the needs and interest of the manufacturer; Marketing revolves around the needs and wants of the costumer;
- **Marketing** is the process of understanding and satisfying the needs of the costumer. Production and sales is to satisfy a costumer at a profit;
- **Marketing** consists of all those activities that are associated with planning, product promotion, place of promotion, price of product and distributing the product or service.

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Marketing & Sales: The difference!

- **Marketing** starts with the identification of the costumer needs, and if it doesn't exist Marketing creates the need.
- **Marketing** creates a costumer. Marketing process does not end after sales of product or service to the costumer. It is for a very long term. It is a continuous process.
- It involves building relationship with the costumer and creating value for the costumer.
- It is perceived that **Marketing** is a long chain of activities which contains production, packing, promotion, pricing, distribution and then sales.

Marketing & Sales: The difference!

- Costumer needs is the driving force behind all these activities.
- In **marketing**, the market shares takes the 2^{nd} position, the Mind share takes the 1^{st} position. A truly marketing minded organization tries to create value satisfying goods and services, which the costumers will want to buy.
- What an organisation offers for sales is determined by the costumer and not by the seller.
- The seller learns from the costumer, and the product offered for sales becomes the consequence of the marketing efforts.

Marketing & Sales: The difference!

- **Sales** are concerned with the tricks and techniques of selling products in exchange of cash for the company's products and sales does not concentrate on the value satisfaction that the exchange is all about.

- **Marketing**, on the other hand, views the entire business as a creative tool to discover, crease, arouse and satisfy costumer needs.

An introduction to Finance

- **Finance** is the study of how and under what terms savings (money) are allocated between lenders and borrowers.
- It is distinct from economics in that it addresses not only how resources are allocated but also under what terms and through what channels.

An introduction to Finance

- **Corporate Finance** is concerned with the efficient and effective management of the finances of an organisation in order to achieve the objectives of that organisation. This involves:
  - Planning & Controlling the provision of resources (where funds are raised from);
  - Allocation of resources (where funds are deployed to);
  - Control of resources (whether funds are being used effectively or not).

An introduction to Finance

Financial analysis in general is a set of techniques and methods used by analysts in order to provide to stakeholders reports on financial condition of the company in the past or in the future.

It always refers to assessment of the business and deals with planning, budgeting, monitoring, forecasting or improving financial details within organization.

An introduction to Finance

The goals of financial analysis as follows:

- Assessing the profitability, solvency, liquidity and stability of the company,
- Giving inside into business valuation of company,
- Giving a reason and base for decision making process.

An introduction to Finance

Analysts use financial indicators to track profitability of the business. The basic classification includes:

- **Profitability** – ratio provides an insight to the degree of success in generating wealth for the owners.
- **Efficiency** – ratio assesses the level of using resources for achieving the results.
- **Liquidity** – availability of sufficient resources to meet financial obligations when they become due.

An introduction to Finance

Analysts use financial indicators to track profitability of the business. The basic classification includes:

- **Financial gearing** – relationship between the contribution to financing the business made by the owners of the business and the amount contributed by the lenders.

- **Investment** – ratio assesses the returns and performance of shares in a particular business form a perspective of shareholders.

An introduction to Finance

The difference between **Corporate Finance, Financial Accounting** & **Management Accounting** is as follows:

- **Corporate Finance** is inherently forward-looking and based on cash flows.
- **Financial Accounting** is historic in nature and focuses on profit rather than cash.
- **Corporate Finance** is concerned with raising funds and providing a return to investors.
- **Management Accounting** is concerned with providing information to assist managers in making decisions within the company.

An introduction to Finance

Corporate Finance addresses the following three questions:

1. What long-term investments should the firm engage in?
2. How can the firm raise the money for the required investments?
3. How much short-term cash flow does a company need to pay its bills?

Five foundational principles of Finance

- Cash flow is what matters.
- Money has a time value.
- Risk requires a reward.
- Market prices are generally right.
- Conflicts of interest cause agency problems.

"…while it is not necessary to understand finance in order to understand these principles, it is necessary to understand these principles in order to understand finance."©

Principle 1: Cash flow is what matters

- Accounting profits are not equal to cash flows. It is possible for a firm to generate accounting profits but not have cash or to generate cash flows but not report accounting profits in the books.
- Cash flow, and not profits, drive the value of a business.
- We must determine incremental cash flows when making financial decisions.
- Incremental cash flow is the difference between the projected cash flows if the project is selected, versus what they will be, if the project is not selected.

Principle 2: Money has a time value

- A Euro received today is worth more than a euro received in the future.

- Since we can earn interest on money received today, it is better to receive money earlier rather than later.

Principle 3: Risk requires a Reward

- We won’t take on additional risk unless we expect to be compensated with additional reward or return.
- Investors expect to be compensated for “delaying consumption” and “taking on risk”.
- Thus investors expect a return when they put their savings in a bank (i.e. delay consumption) and they expect to earn a higher rate of return on stocks relative to bank savings account (i.e. taking on risk).

Principle 4: Market prices are generally right

- In an efficient market, the prices of all traded assets (such as stocks and bonds) at any instant in time fully reflect all available information.
- Thus, stock prices are a useful indicator of the value of the firm. Prices changes reflect changes in expected future cash flows. Good decisions will tend to increase the stock prices and vice versa.
- Note there are inefficiencies in the market that may distort the prices

Principle 5: Conflicts of interest cause agency problems

- The separation of management and the ownership of the firm creates an agency problem.
- Managers may make decisions that are not consistent with the goal of maximizing shareholder wealth.
- Agency conflict is reduced through monitoring (ex. Annual reports), compensation schemes (ex. stock options), and market mechanisms (ex. Takeovers).

The role of Finance in Business!

There are three broad issues addressed by the study of finance:

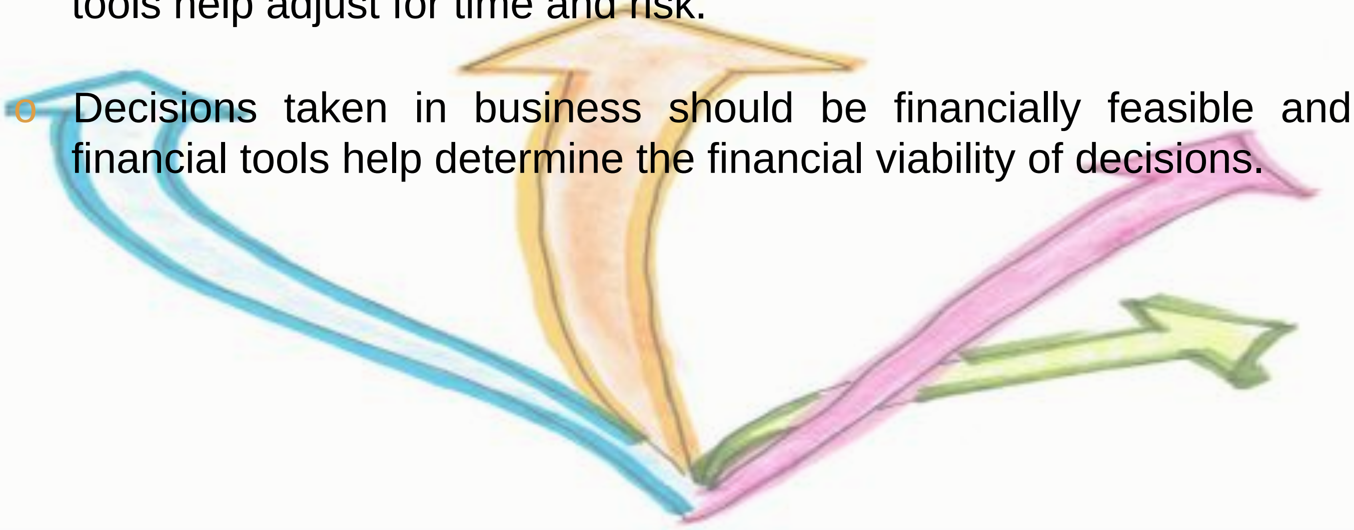
Where to Invest?
Capital budgeting decision.

How to raise money to fund the investment?
Capital structure decision.

How to manage cash flows from daily operations?

Knowledge of Financial Tools

- Knowledge of financial tools is relevant for decision making in all areas of business (be it marketing, production etc.).
- Decisions involve an element of time and uncertainty and financial tools help adjust for time and risk.
- Decisions taken in business should be financially feasible and financial tools help determine the financial viability of decisions.



Knowledge of Financial Tools

The best way to understand Finances in the company, is to understand the financial reports, delivered by the accountants.

There are **3** main financial reports:

- **Balance sheet:** also known as the statement of financial position.
- **Income statement:** also known as the profit and loss account.
- **Cash flow statement**

Balance Sheet

- A **balance sheet** is a snapshot of a business financial condition at a specific moment in time, usually at the close of an accounting period.
- It comprises assets, liabilities, and owners or stockholders equity.
- Assets and liabilities are divided into short- and long-term obligations including cash accounts such as checking, money market, or government securities. At any given time, assets must equal liabilities plus owners equity. An asset is anything the business owns that has monetary value.
- Liabilities are the claims of creditors against the assets of the business.

Balance Sheet

The analysis of a **balance sheet** should help answer the following questions:

1. Is the business in a position to expand? Can the business easily handle the normal financial ebbs and flows of revenues and expenses?

2. Should the business take immediate steps to bolster cash reserves?

Balance Sheet

The analysis of a **balance sheet** should help answer the following questions:

3. Is the receivables cycle lengthening?
4. Can receivables be collected more aggressively? Is some debt uncollectable?
5. Has the business been slowing down payables to forestall an inevitable cash shortage?

Example Company
Balance Sheet
December 31, 2016

ASSETS

Current assets	
Cash	$ 2,100
Petty cash	100
Temporary investments	10,000
Accounts receivable - net	40,500
Inventory	31,000
Supplies	3,800
Prepaid insurance	1,500
Total current assets	89,000
Investments	36,000
Property, plant & equipment	
Land	5,500
Land improvements	6,500
Buildings	180,000
Equipment	201,000
Less: accum depreciation	(56,000)
Prop, plant & equip - net	337,000
Intangible assets	
Goodwill	105,000
Trade names	200,000
Total intangible assets	305,000
Other assets	3,000
Total assets	$ 770,000

LIABILITIES

Current liabilities	
Notes payable	$ 5,000
Accounts payable	35,900
Wages payable	8,500
Interest payable	2,900
Taxes payable	6,100
Warranty liability	1,100
Unearned revenues	1,500
Total current liabilities	61,000
Long-term liabilities	
Notes payable	20,000
Bonds payable	400,000
Total long-term liabilities	420,000
Total liabilities	481,000

STOCKHOLDERS' EQUITY

Common stock	110,000
Retained earnings	220,000
Accum other comprehensive income	9,000
Less: Treasury stock	(50,000)
Total stockholders' equity	289,000
Total liabilities & stockholders' equity	$ 770,000

The notes to the sample balance sheet have been omitted.

Income statement

- An **income statement,** otherwise known as a profit and loss statement, is a summary of a company's profit or loss during any one given period of time, such as a month, three months, or one year.

- It records all revenues for a business during this given period, as well as the operating expenses for the business.

- **Income statement** is used to track revenues and expenses so that you can determine the operating performance of your business over a period of time. Small business owners use these statements to find out what areas of their business are over budget or under budget.

Income statement

- Specific items that are causing unexpected expenditures can be pinpointed, such as phone, fax, mail, or supply expenses.
- Income statements can also track dramatic increases in product returns or cost of goods sold as a percentage of sales. They also can be used to determine income tax liability.
- It is very important to format an income statement so that it is appropriate to the business being conducted.
- Income statements, along with balance sheets, are the most basic elements required by potential lenders, such as banks, investors, and vendors. They will use the financial reporting contained therein to determine credit limits.

Gary's Garden Furniture
Income Statement
January 1—December 13, 2013

	$	$
REVENUES		
Sales	350,000	
Interest Revenues	1,000	
Gains	2,000	
Total Revenues		**353,000**
EXPENSES & LOSSES		
Cost of Goods Sold	125,000	
Salaries	110,000	
Rent	7,000	
Utilities	2,000	
Interest Expense	1,000	
Losses	1,000	
Bad Debt Provision	4,000	
Depreciation	8,000	
Total Expenses & Losses		**(258,000)**
NET INCOME		**95,000**

Cash flow statement

- **The cash flow statement** reports the cash generated and used during the time interval specified in its heading.
- The period of time that the statement covers is chosen by the company.

Categories of cash statements are as follows:

- **Operating activities:** Converts the items reported on the income statement from the accrual basis of accounting to cash.
- **Investing activities:** Reports the purchase and sale of long-term investments and property, plant and equipment.
- **Financing activities:** Reports the issuance and repurchase of the company's own bonds and stock and the payment of dividends.
- **Supplemental information:** Reports the exchange of significant items that did not involve cash and reports the amount of income taxes paid and interest paid.

Operating activities:

Operating activities includes:

- receipts from the sale of goods or services,
- receipts for the sale of loans,
- debt or equity instruments in a trading portfolio,
- interest received on loans,
- dividends received on equity securities,
- payments to suppliers for goods and services,
- payments to employees or on behalf of employees.

Investing activities:

Investing activities includes:

- purchase of an asset (assets can be land, building, equipment, etc.),
- loans made to suppliers or customers.

Financing activities:

Financing activities includes:

- proceeds from issuing short-term or long-term debt,
- payments of dividends,
- payments for repurchase of company shares,
- repayment of debt principal, including capital leases, for non-profit organizations,
- receipts of donor-restricted cash that is limited to long-term purposes,
- dividends paid,
- sale or repurchase of the company's stock,
- net borrowings and payment of dividend tax.

Supplemental information:

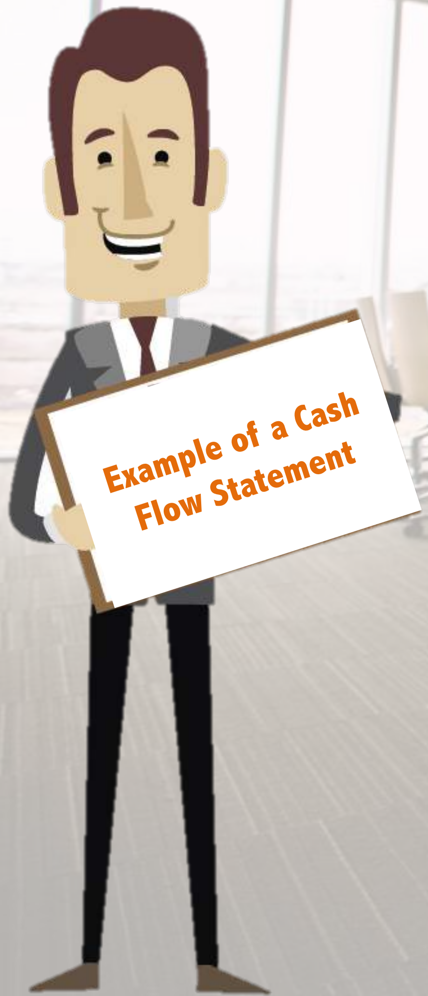
Items which are added back to the net income figure (which is found on the Income Statement) to arrive at cash flows from operations generally include:

- depreciation,
- differed tax,
- amortization (loss of intangible asset value over time),
- any gains or losses associated with the sale of a non-current asset, because associated cash flows do not belong in the operating section (unrealized gains/losses are also added back from the income statement).

Cash Flow Statement

For the Year Ended December 31, 2016

Cash Flow from Operations	
Cash receipts from customers	86,772
Cash paid for inventory	(7,400)
Cash paid for wages	(53,000)
Net Cash Flow from Operations	**26,372**
Cash Flow from Investing	
Cash receipts from sale of property and equipment	13,500
Cash paid for purchase of equipment	(17,500)
Net Cash Flow from Investing	**(4,000)**
Cash Flow from Financing	
Cash paid for loan repayment	(5,000)
Net Cash Flow from Investing	**(5,000)**
Net Increase in Cash	**17,372**



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Stay tuned for Chapter 5