Course overview

1. Introduction
   - The value of money – inflation
   - Interest

2. Financing organisations
   - Business plans
   - Sources of capital
   - Financial reporting

3. Financing projects and appraising investments
   - Net present value, internal rate of return

4. Pricing products and contracts
   - Direct and indirect costs
   - Relationship between costs and price
   - Competitive tendering
2. Financing Organisations

- Before we look at projects, it is helpful to consider how organisations themselves are funded
  - This, in turn will affect how projects are funded within the organisation
- Engineering organisations are very diverse in shape and size
- Possibilities can include
  - **Sole trader**
    - Somebody who owns all of the business (and usually runs it)
  - **Partnership**
    - Shared ownership between two or more individuals
  - **Limited Company**
    - Formal company structure with ‘limited liability’
  - **Public Limited Company (plc)**
    - as above, but shares are freely traded on the stock exchange
    - i.e. anyone can buy a share of the company
2.1 Types of organisation
- Financial liabilities

- A **sole trader** is not separated financially from his/her trading activities. If the business fails he/she is personally liable for the losses and may be made personally bankrupt as a result.

- **Partnerships** are generally similar, with the added twist that each partner may personally liable for the whole partnership debt, not just his/her share
  - This feature is to protect creditors if one or more partners cannot be traced (for example)
  - It is not, however, reassuring for the individual partners(!)
  - The concept of individual liability for trading activities might be seen as acting as a brake on entrepreneurial activity
Limited Liability companies

- The concept of **limited liability** dates back to the 17th century
- A **company** with ‘articles of association’ is set up
- This company has a ‘persona’, i.e. it is treated in some ways as a person:
  - The company is **liable for losses up to the limit of its assets**
  - Those who share in the company’s ownership (the ‘**shareholders’** ) can lose their financial investment in the company, **but no more**
- It is now possible to have **limited liability partnerships** (LLPs) as well as limited companies
Private and public companies

- When a private company is formed, a number of individuals put in money to establish the business
- This is called ‘capital’
- Shares are issued for a value matching this capital and are allocated to each shareholder in proportion to their investment
- There is therefore a nominal value to each share
- If the company does well, it may become ‘worth more’ than the total nominal value of the shares
  - e.g. because it is producing good profits people will want to own the shares and will be prepared to pay a premium over the nominal value
- Similarly if a company performs badly, its value may become less than the nominal value of the shares
  - E.g. because losses have been built up during trading
Private and public companies

- It is clear that the value of shares may vary from the nominal value of the initial investment.

- If one of the shareholders wishes to sell his or her investment they will normally want to realise this new value rather than the nominal investment.

- It is not sensible to cease trading in order to sell the assets and value the company.
  - In any case, the company is likely to be worth more as a going concern than the total value of its assets.

- So there needs to be a means of valuing a shareholder’s investment at a time of sale.
  - The principal means of valuation is what someone else is prepared to pay for them.
In a **private company**, the shares are **not** generally available to the public

- If a shareholder wishes to sell they must find an **individual** to sell to – this will set the price
- It is common practice in many private companies for the shareholder to be required to offer the shares at this price to existing shareholders before selling them to an ‘outsider’

For **larger companies**, this is an inefficient mechanism and shares are generally offered **on the open market**

- For this to happen, the company must be **listed on a stock exchange** (where shares or ‘stocks’ are bought and sold)
- Companies whose shares are listed in this way are known (in the UK) as **public limited companies** ‘plcs’
- A private companies may convert to a plc by a ‘**flotation**’ (a public offer of shares for sale)
Share prices quoted on the stock exchange reflect the price at which they are changing hands.

This is the ‘market’ view of the value of the company.
2.3 Business plans

- In order to get a **business** established, you will need to have some **money**
- Unless you are a sole trader, this will involve getting a **loan** and/or persuading others to **invest** in your business (become **shareholders**)
- Either way, you will need to convince the bank or the prospective shareholders that you
  - Will be able to **repay the loan**
  - Will make a **profit** (i.e. increase the value of the company for the shareholders)
- There will be chance to look at other aspects of business plans in the Technology Strategy lectures
  - Here we will concentrate on financial aspects
Business plans - definitions

- **Turnover** is a measure of **output** (i.e. the value of sales)
- **Direct costs** are a measure of the **costs which vary with the output** (normally more or less in proportion)
  - E.g. materials, energy, direct labour
- **Indirect costs** or overheads are **costs which don’t vary with output**
  - E.g. premises costs, administration etc
  - Precise division between direct and indirect costs is often a matter for debate
  - These are sometimes called ‘fixed costs’, but they are not generally fixed for all possible values of turnover, so this term can be misleading
- **Profit** is the **unspent surplus** at the end of the accounting period (year)
  - Profit = turnover – direct costs – indirect costs
Elements of a business plan

- A good place to start is to estimate the situation **once a business has been established** (i.e. is in ‘steady state’)
  - Although, as we will see, there is also the question of how to get to a steady-state

- One needs to estimate:
  - **Turnover** (what you think you can produce and what the market will pay for it)
  - **Direct costs** (what it will cost to manufacture the items)
  - **Indirect costs** (estimate of costs which do not vary directly with production)
Example

- Turnover: £10.0m
- Direct costs: £7.5m
- Indirect costs: £2.0m
- Profit: £0.5m

Note (obviously) that direct costs + indirect costs + profit = turnover.

Indirect costs + Profit (£2.5m in this case) is sometimes called ‘Gross profit’. This is the excess over direct costs and represents the contribution towards indirect costs and profit.

Note that in this case it is 25% of turnover – Particular products, services, or contracts should therefore seek to make a contribution to gross profit at around this level.

Because of indirect costs, there is a minimum turnover, where the profit becomes negative (a loss).

Note that here we are using a rather simplistic definition of profit which will need to be refined later.
Deviations from the plan: Marginal selling

- If turnover doesn’t meet expectations, profit can be reduced or a loss may be incurred **because of indirect costs**.
- In this situation it may be best to **reduce prices**, so that the contribution to gross profit on each item is reduced.
- **This is likely to lead to increased sales** and, as long as the items are making some contribution to gross profit, you may be better off than otherwise. i.e. ‘any contribution to indirect costs is better than none’
- This is one reason why companies like Easyjet and Ryanair can sell flights for so little (and also why shops have sales just after Christmas)
- One has to be careful, however, that not all business is marginal (something has to cover the bulk of the indirect costs)
Deviations from the plan: Overtrading

- If things **go better than expected**, turnover will be higher than planned and the planned indirect costs will all be covered part-way through the year.
- It will therefore appear that all of the contribution to gross profit can be taken as net profit.
- It is tempting, therefore, to **reduce prices** and **increase turnover** still further.
- However, if turnover is much bigger than planned, the indirect costs are also likely to increase.
- It may not, therefore, be a good idea to take a reduced gross profit if turnover is up. Indeed, it could be argued that it would be better to stick to the original planned turnover and increase prices to keep sales on target.
In general, organisations do not cease trading because they make a loss.

The principal reason for ceasing to trade is that they have run out of cash.

This can, of course, occur because a company has made a series of losses, but a profitable company can also run out of cash.

A good rule of thumb might be that a company needs ‘working capital’ of around 20% of turnover.
Working capital - an illustration

- Suppose a company has a business plan which envisages a profit of £2.5m p.a. on a turnover of £10m once the business has become established.

- However, in the first year there will be additional costs associated with:
  - Buying or leasing premises
  - Buying equipment
  - Recruiting staff
  - Developing the product
  - Marketing and advertising

- Sales are also likely to be down for the first few years, as it will take time to establish production and for the product to become known in the market.

- This is an example of the difficulty of achieving the ‘steady state’ situation.
In the example shown above it can be seen that the company makes a profit from year 4 onwards (although we will see later that this simplified form of presenting the accounts leaves something to be desired).

However, startup costs mean initial losses are not repaid until year 10.

It is clear that the company will need some source of funds to enable it to meet the startup costs and to continue to trade until year 10.

At the ‘worst point’ (year 3), the accumulated loss is £3.5m.

This represents the minimum working capital for the business.

It does not, of course, allow for any unforseen deviations from the plan.

Note, that the profit of £0.5m represents quite a good return (14%) on the working capital of £3.5m. If the business plan is sound, somebody should be prepared to lend you the money.
Cash flow

- So far we have looked at the need for cash on an ‘end of year’ basis.
- However, it is also important to examine the cash situation more frequently (e.g. monthly, weekly or even daily)
- Bills and payments may not always come in regularly
- An organisation must always have sufficient cash to meet its obligations (e.g. paying staff, suppliers) whenever these arise
- This observation leads to the concept of cash flow and the need for a cash flow forecast
- This is also likely to be an issue at a project level
  - When are the expenses incurred
  - When will the payments be made
  - Who will make up any difference (and at what cost)?
Cash flow

- Cash flow is a particular issue for **contracting companies** (i.e. where their business is a relatively small number of high value contracts)
- In this situation, a lot of expenditure may be incurred before payment is received
- It is important to **plan** how the income and payments will be spread over time and what the consequences will be for the amount of cash required
A typical cash flow forecast like the graph shown on the right will be based on a monthly estimate of payments made and received.

In the case shown here, the cash balance is always positive (though only just in August).

More typically an organisation may need to have an overdraft with the bank (at least at some point during the year).
Improving cash flow

- There are a number of ways to **improve cash flow**
- These include
  - Requiring money **in advance** or ‘staged payments’ through a contract
    - This will almost always be the case with an external contract
  - Paying bills **late**
    - Normally invoices will have a ‘due by’ date, but if you don’t pay by then it is unlikely that anything serious will happen. However, you need to consider that if you don’t pay bills on time suppliers may cease to deal with you
    - Remember that other organisations will be seeking to improve their own cash flow – your customers may not pay **you** on time!
An organisation must **always** have access to sufficient **cash** to be able to meet its financial obligations

It is a **criminal offence** in the UK to trade whilst **knowingly insolvent** (i.e. having insufficient assets to cover one’s liabilities)
  – Directors of a company can face a jail sentence if they break the law in this way.

When considering project finance, a cash flow forecast is important, as well as considering the overall cost
2.4 Sources of capital

- We have seen that an organisation needs working capital in order to function effectively.

- It is therefore important to consider where this capital might come from and what the consequences might be.
  - If a project needs finance, this will have to come from the same type of sources (either directly or indirectly).

- At its simplest, a sole trader might put some of his or her own money into their business.
  - If he or she has personal debts (e.g. a mortgage) this is effectively the same as borrowing from a bank.
  - Of course it is possible that they may get a better interest rate on a secured personal loan (mortgage), but there are risks (e.g. if the business has difficulties the trader may lose their house to the bank).
    - It is also more tax-efficient to have a business loan, as the interest can be offset against profits (this often more than makes up for the difference in interest rates).
Sources of capital

- An organisation needs to establish working capital (at least initially)
  - In time one might hope that the company will generate some working capital of its own (e.g. by accumulated profits)

- Several possibilities are available
  - Borrowing – usually from a bank or other financial organisation
  - Issuing shares – i.e. selling part of the company to one or more individuals (e.g. a venture capitalist, family and friends, or a more formal share issue).

- Borrowing will cost money
  - Either as interest or as dividends to the shareholders
Borrowing from a bank

- Borrowing from a bank may take the form of
  - A **fixed loan** with a given duration in terms of time
    - Capital repayments may be required during the term of the loan or in one lump sum at the end
  - A **variable loan** (overdraft), which has no specific term or repayment schedule
    - There will, however, be a limit to the overdraft facility

- Borrowing from a bank will entail the payment of **interest**
  - As we have seen before, the interest rate will depend on the amount of risk involved
  - In assessing the risk, the bank will wish to see the **business plan**

- Beware of the **loan conditions** – sometimes the bank will have the right to terminate the loan without much warning (e.g. if it is unhappy with how the business is going)
  - In practice an organisation will need to keep the bank informed of its financial position and future plans
Borrowing from a bank

- Interest rates will also be lower if the organisation can offer some ‘security’
  - Security is some fixed asset with a value, which the bank can sell to recover its money if the business fails
  - Examples might be a building, or expensive machinery

- Banks generally have second call on the assets of a failed business
  - The government has first call for unpaid taxes
  - Unsecured creditors (such as suppliers who have not been paid or customers who have paid but not received goods) will not get anything until the government and the banks have received their money
Financing using shares

- The company will arrange to issue shares, which may be purchased for a given amount each
  - For a small company, these may be sold to the directors themselves, or to their family and friends, or to one or more venture capitalists
- The shares will have a nominal value (their purchase price)
- For example, if a company issues 100,000 shares at £10 each it will have a working capital of £1 million
Financing using shares

- The shareholders will be expecting a return from their shareholding
  - In terms of **capital growth** (the company will grow and will become worth more than the nominal value of the shares)
  - In terms of a **dividend**, an amount which is paid annually per share to the shareholders
    - The amount of the dividend is not fixed and can be varied by the directors according to the company’s circumstances

- The articles of association will give the shareholders some powers (e.g. they may dismiss directors or wind up the company)

- In general, share capital is more **flexible** than a bank loan, but it may not be easy to find potential shareholders

- Most companies are financed by a **mix** of shares and loans
2.5 Reporting financial status

- We have seen that both banks and shareholders wish to know how the company is going.
- There is a need to report the financial status in a standardised form.
- This leads to the concept of Company Accounts, which are a form of financial accounts.
- Companies in the UK are required to submit company accounts annually.
  - These must be checked or audited by an independent accountant.
  - Even a sole trader will need to prepare appropriate financial accounts for taxation purposes.
- Note that these formalised annual statements of financial position (financial accounts) are quite different from management accounts, which are internal documents produced to try and help the management make financial and other decisions.
- For projects, management accounts are usually sufficient, although some form of audited financial accounts may be required at the project end.
The simplest form of account is an income and expenditure statement.

This is really just an annual cash flow record. It records the income received and the expenditure made.

It might be thought that the difference between the income and expenditure would be the profit for the year, but as we shall see, this is not so.
This shows that expenditure has *exceeded* income during the year by £169,000. At first sight, this might seem worrying, however, we should note that a significant piece of expenditure has been ‘equipment’ and that this is not likely to occur every year.

The income and expenditure statement is not, therefore, a fair representation of the trading situation:

- We should note, however, that it is *important for cash flow*. Unless the company had access to additional capital of £169 000 it would not have been able to continue trading during the year.
Accounting for capital purchases - depreciation

- As we saw on the previous slide, **large capital purchases** can make a big difference to the income and expenditure statement.

- Often these purchases (e.g. equipment or building) will satisfy the needs of the business for many years:
  - They will still have a value at the end of the year
    - E.g. they could be sold ‘second hand’ for some value (probably less than the purchase price)
  - We need some way of incorporating this feature into the accounts
    - This is called **accounting for depreciation of capital assets**
Suppose a piece of equipment is purchased for £500,000 and has an expected life of 10 years and that the value at the end of this period is expected to be negligible.

We need some way of recognising the decrease of the ‘value’ of the equipment between these two points. This is called depreciation or depreciating the asset.

These two points are the only ‘fixed’ points in the calculation. Everything else is a matter of accounting policy (although some approaches are more sensible than others).

- We could get the asset accurately valued at the end of every year, but this would be time consuming, expensive, and if the asset is not common it may be difficult to establish a very accurate value anyway.
- What we need is a good ‘general purpose’ approach which will be acceptable to the auditors and which will give roughly the right answer.

If we are using a depreciating asset in a project, some form of charge should be made to account for this.
A simple approach is linear depreciation. For our example we would decrease the value by $1/10$th each year for 10 years until its ‘book value’ was zero.

In general this doesn’t really reflect how real assets depreciate.

E.g. note how a typical car loses nearly half its value in the first year, but depreciates much more slowly after this – one good reason for buying a second-hand car.
An alternative is to depreciate or ‘write-off’ a fixed proportion of the current asset value each year (e.g. 25%)

For income tax purposes, the government allows sole traders and partners to write off 40% of an assets value in the first year and 20% thereafter. Policies for companies are similar

Note that depreciating a fixed proportion of the current value each year means that the asset never reaches zero value. However, if the proportion is chosen correctly the residual value at the end of the lifetime will be negligible
Suppose that a fixed proportion $\lambda$ is depreciated in each time interval, $t$

Then the value $V(t+1) = (1-\lambda) \cdot V(t)$

Hence, $V(t) = V_0(1-\lambda)^t$

where $V_0$ is the initial value

Using this approach, **depreciated value decays exponentially**:

$$dV = (1-\lambda)V \, dt$$
Depreciation policies

- The correct policy will depend on the type of asset.
- It is, of course, possible to write the whole value off in year 1 (which brings us back to the income and expenditure position).
- We should also be aware that applying different depreciation policies for capital assets will make a big difference to the calculated profit in a given year.
  - Auditors should not allow a company to state a position which is too far from reality.
Incorporation of depreciation into accounts – the profit and loss statement

- If we have purchased a capital item we can spread the purchase cost over a number of years and only need to include the depreciation element in the accounts, not the purchase price.

- Hence, the example set of accounts we had previously become

<table>
<thead>
<tr>
<th>Income (£)</th>
<th>Expenditure (£)</th>
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<tbody>
<tr>
<td>Sales 800000</td>
<td>Staff costs 200000</td>
</tr>
<tr>
<td>Interest received 1000</td>
<td>Material costs 100000</td>
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<tr>
<td></td>
<td>Premises costs 100000</td>
</tr>
<tr>
<td></td>
<td>Depreciation 125000</td>
</tr>
<tr>
<td></td>
<td>Interest on capital 50000</td>
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<tr>
<td></td>
<td>Taxation 20000</td>
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<tr>
<td>Total 801000</td>
<td>595000</td>
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<tr>
<td>Profit 206000</td>
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- The deficit of £169,000 on the income and expenditure account has become a profit of £206,000
  - This is because something was purchased that still has value
Obviously we need to keep track of what capital items we have to depreciate in the future.

This is done in an account called the ‘balance sheet’, which represents the value of the business at the end of the accounting period.

Capital items purchased must represent an addition to the value of the business.

Similarly, depreciation must be transferred from the profit and loss account and represents a deduction in the value of the business.
An example balance sheet

<table>
<thead>
<tr>
<th>Fixed assets</th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Brought forward</td>
<td>0</td>
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<tr>
<td>Additions at cost</td>
<td>500000</td>
<td>less depreciation</td>
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<tr>
<td>Fixed assets carried forward</td>
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<table>
<thead>
<tr>
<th>Current assets</th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Stock</td>
<td>50000</td>
<td></td>
</tr>
<tr>
<td>Debtors</td>
<td>10000</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>1000</td>
<td></td>
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<tr>
<td>Total</td>
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<table>
<thead>
<tr>
<th>Current liabilities</th>
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<tbody>
<tr>
<td>Bank loans and overdrafts</td>
<td>200000</td>
<td></td>
</tr>
<tr>
<td>Creditors</td>
<td>500</td>
<td></td>
</tr>
<tr>
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<td></td>
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| Total assets less current liabilities | 235500 |

<table>
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<tr>
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<tbody>
<tr>
<td>Share capital</td>
<td>100</td>
<td></td>
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<tr>
<td>Share premium</td>
<td>29400</td>
<td></td>
</tr>
<tr>
<td>Retained profit (from P + L account)</td>
<td>206000</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>235500</td>
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</table>
Other features of the balance sheet

A distinction is made between *fixed assets* (buildings, machinery etc.) which are owned by the company but not directly part of its day-to-day business.

- ‘Current assets’ include stock (purchased components, unsold finished products, etc) as well as cash in the bank and ‘debtors’ (i.e. people who owe you money)
- Note that the increase in value of the balance sheet is equal to the retained profit (from the P+L account) – at least in a simple case

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Similarly, *current liabilities* represents items that the company owes (the bank and unpaid invoices from suppliers).

The difference between assets and liabilities is the ‘book’ value of the company.

This can be thought of as having three parts:
- The original value of the shares
- The profit made in the current year
- The remainder of the value is known as the ‘share premium’ - this is effectively the increase in the value of the company over and above the original share value

If a company has shares traded on the stock market a value can also be calculated from these. This will normally differ from the value on the balance sheet.
- Investors will be taking into account the perceived value of future profits

### Fixed assets

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### Total assets less current liabilities

235500

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</tr>
<tr>
<td>Retained profit (from P + L account)</td>
<td>206000</td>
</tr>
<tr>
<td>Capital and reserves carried forward</td>
<td>235500</td>
</tr>
</tbody>
</table>

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One difficult issue on the balance sheet concerns ‘Goodwill’. This is the value of a company’s reputation and relationships with its customers. This can have significant value, but it is very difficult to quantify. The extent to which it can and should be included on a balance sheet is a matter for debate.

There are good reasons for including goodwill as an asset (e.g. it has cost money to develop it and potential purchasers of a company are likely to pay for it). However, there is also the potential for making a company appear more valuable than it actually is – auditors need to be aware of this.
Financing organisations - summary

- Organisations normally seek to make a profit (or at least a surplus), but need not do so in every accounting period
- They do, however, need to ensure that they have adequate cash resources to meet daily requirements
  - Cash flow is often more important than profit – certainly in the short term
- Organisations therefore need an appropriate amount of working capital, which must generally be borrowed
- Business plans are useful as a means of predicting profit and loss and cash flow
Financial accounts provide a (reasonably) standard method of reporting the financial status of an organisation.

A policy needs to be decided for depreciation of capital assets.

This will influence the profit/loss figure, but it will not affect the cash flow situation.

All of these organisational considerations impact on finance at a project level.