Cambridge

IGCSE

Business studies

CODE: (0450)

Section 05

Financial information and financial decisions

Chapter 22
Business finance: needs and sources

What do Finance departments do?

Finance departments fulfil a very important role in business. They have the following responsibilities:
» Recording all financial transactions, such as payments to suppliers and revenue from customers.
» Preparing final accounts.
» Producing accounting information for managers.
» Forecasting cash flows.
» Making important financial decisions, for example, which source of finance to use for different purposes within the business.

The main reasons why businesses need finance

Finance is money. We all need money to purchase the goods and services we require – everyday goods, like food, but also more expensive items such as a house or car. Businesses need finance too – and this is often called 'capital'.

Starting up a business

When an entrepreneur plans to start their own business, they should think about all of the buildings, land and equipment they will need to buy in order to start trading. The finance needed to launch a new business is often called **start-up capital.**

Expanding an existing business

The owners of a successful business will often take a decision to expand it in order to increase profits. Additional non-current (fixed) assets could be purchased – such as larger buildings and more machinery. Another business could be purchased through a takeover. Other types of expansion include developing new products to reach new markets.

Additional working capital

Working capital is often described as the 'life blood' of a business. It is finance that is constantly needed by firms to pay for all their day-to-day activities. They have to pay wages, pay for raw materials, pay electricity bills and so on.

In all three cases above, businesses may need finance to pay for either **capital expenditure** or **revenue expenditure**. It is important to understand the difference.

» Capital expenditure is money spent on non-current assets, such as buildings, which will last for more than one year. These assets are needed at the start of a business and as it expands.

» Revenue expenditure is money spent on day-to-day expenses, for example, wages or rent.

Definitions to learn

Working capital is the finance needed by a business to pay its day-to-day costs.
Capital expenditure is money spent on non-current (fixed) assets which will last for more than one year.
Revenue expenditure is money spent on day-to-day expenses which do not involve the purchase of a long-term asset, for example, wages or rent.

Definitions to learn

Start-up capital is the finance needed by a new business to pay for essential non-current (fixed) and current assets before it can begin trading.

Financial needs of business

Sources of finance

There are many different sources of finance available. It is common to split them up, or classify them, into different groups. The two most common ways of doing this are:

» Internal or external sources of finance
» Short-term or long-term sources of finance.

Internal finance

The most common examples of internal finance are as follows.

Retained profit

This is profit kept in the business after the owners have taken their share of the profits. It has the following advantages:

» Retained profit does not have to be repaid, unlike, for example, a loan.

» There is no interest to pay – the capital is raised from within the business.

There are disadvantages too:
» A new business will not have any retained profits.
» Many small firms' profits might be too low to finance the expansion needed.
» Keeping more profits in the business reduces payments to owners.

Sale of existing assets

Existing assets that could be sold are those items of value which are no longer required by the business,
» This makes better use of the capital tied up in the business.
» It does not increase the debts of the business.

However:
» It may take some time to sell these assets, and the amount raised is never certain until the asset is sold.
» This source of finance is not available for new businesses as they have no surplus assets to sell.

Sale of inventories to reduce inventory levels

» This reduces the opportunity cost and storage cost of high inventory levels.

However:
» It must be done carefully to avoid disappointing customers if not enough goods are kept as inventory.

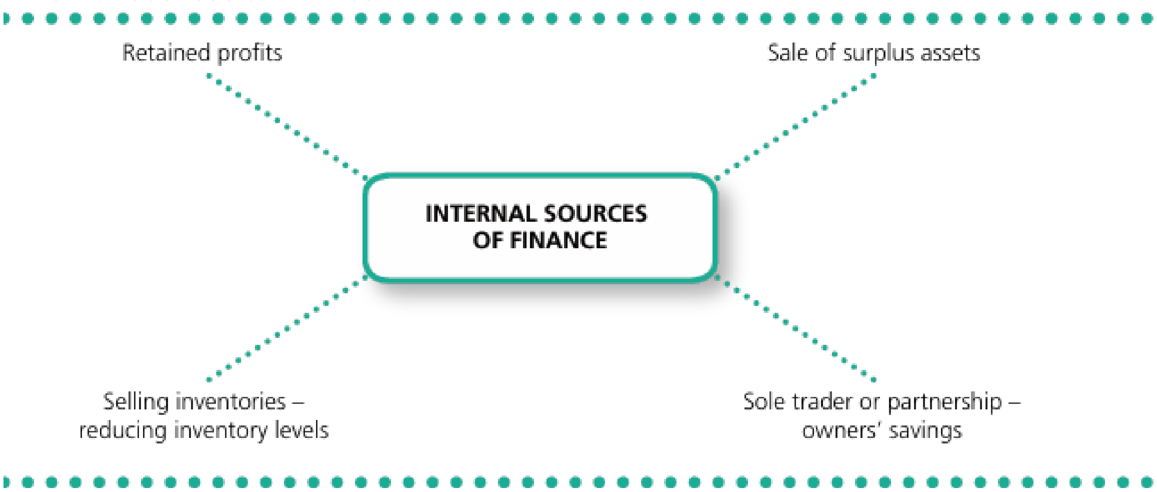
Owners' savings

A sole trader or members of a partnership can put more of their savings into their unincorporated businesses. the owners of these firms are not separate from their businesses and therefore such finance is called internal. Advantages include the following:

» It should be available to the firm quickly.
» No interest is paid.

However:
» Savings may be too low.
» It increases the risk taken by the owners as they have unlimited liability

Internal sources of finance



External finance

The most common forms of external finance are as follows.

Issue of shares

This source of finance is only possible for limited companies.
» This is a permanent source of capital which would not have to be repaid to shareholders.
» No interest has to be paid.

However:
» Dividends are paid after tax, whereas interest on loans is paid before tax is deducted.
» Dividends will be expected by the shareholders.
» The ownership of the company could change hands if many shares are sold, which the original owners might object to.

Bank loans

A bank loan is a sum of money obtained from a bank which must be repaid and on which interest is payable.
» These are usually quick to arrange.
» They can be for varying lengths of time.
» Large companies are often offered low rates of interest by banks if they borrow large sums.

However:
» A bank loan will have to be repaid eventually and interest must be paid.
» Security or collateral is usually required. This means the bank may insist that it has the right to sell some of the property of the business if it fails to pay the interest or does not repay the loan.

Selling debentures

These are long-term loan certificates issued by limited companies.
» Debentures can be used to raise very long-term finance, for example, 25 years.

However:
» As with loans, these must be repaid, and interest must be paid.

Factoring of debts

A debtor is a customer who owes a business money for goods bought. Debt factors are specialist agencies that 'buy' the claims on debtors of businesses for immediate cash.

The debtor will then pay the factor and the 10 per cent represents the factor's profit – when the factor collects payment from the debtor.

» Immediate cash is made available to the business.
» The risk of collecting the debt becomes the factor's and not the business's.

However:
» The business does not receive 100 per cent of the value of its debts.

Grants and subsidies from outside agencies

Outside agencies include, for example, the government.

» These grants and subsidies usually do not have to be repaid.

However:
» They are often given with 'strings attached', for example, the firm must locate in a particular area.

Alternative sources of capital

The sources of finance that have been explained so far are very widely used by existing businesses or start-up businesses with a detailed business plan supported by owners' capital.

Micro-finance

In many low-income developing countries, traditional commercial banks have been very unwilling to lend to poor people – even if they wanted the finance to set up an enterprise. Banks did not lend because:

» The size of the loans required by poor customers – perhaps a few dollars – meant that the bank could not make a profit from the loans

» The poorer groups in society often have no asset to act as 'security' for loans – banks are usually not prepared to take risks by lending without some form of security (assets they can sell if the borrower cannot repay).

Specialist institutions, like Grameen Bank in Bangladesh, provide **micro-finance** or micro-credit to poor people, addressing their financial needs, particularly entrepreneurs.

> **Definitions to learn**
> **Micro-finance** is providing financial services – including small loans – to poor people not served by traditional banks.

Crowdfunding, a popular method for raising finance for new business start-ups, involves encouraging large numbers of people to invest small amounts. However, it's not suitable for raising small amounts, as it's not suitable for small amounts.

> **Definitions to learn**
> **Crowdfunding** is funding a project or venture by raising money from a large number of people who each contribute a relatively small amount, typically via the internet.

Crowdfunding is claimed to have these benefits:
» No initial fees are payable to the crowdfunding platform. Instead, if the finance required is raised, the platform will charge a percentage fee of this amount.

» Allows the public's reaction to the new business venture to be tested. If people are not prepared to invest, it probably is not a very good business idea.

» Can be a fast way to raise substantial sums.

» Often used by entrepreneurs when other 'traditional' sources are not available.

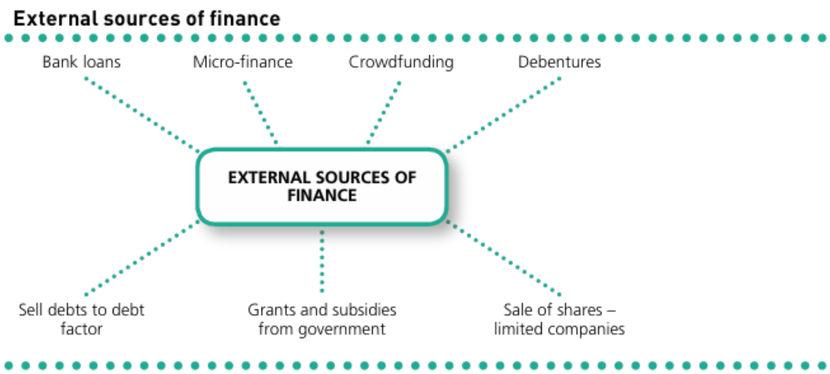
However:

» Crowdfunding platforms may reject an entrepreneur's proposal if it is not well thought out.

» If the total amount required is not raised, the finance that has been promised will have to be repaid.

» Media interest and publicity need to be generated to increase the chance of success.

» Publicising the new business idea or product on the crowdfunding platform could allow competitors to 'steal' the idea and reach the market first with a similar product.



Short-term and long-term finance

Short-term finance This provides the working capital needed by businesses for day-to-day operations. Shortages of cash in the short term can be overcome in three main ways.

Overdrafts

These are arranged by a bank.
» The bank gives the business the right to 'overdraw' its bank account (that is, spend more money than is currently in the account).
» The business could use this finance to pay wages or suppliers but, obviously, it cannot do this indefinitely.
» The overdraft will vary each month with the needs of the business – it is said to be a 'flexible' form of borrowing.
» Interest will be paid only on the amount overdrawn.
» Overdrafts can be cheaper than short-term loans.

However:
» Interest rates are variable, unlike most loans which have fixed interest rates. » The bank can ask for the overdraft to be repaid at very short notice.

Trade credit

This is when a business delays paying its suppliers, which leaves the business in a better cash position.
» It is almost an interest-free loan to the business for the length of time that payment is delayed for.

However:
» The supplier may refuse to give discounts or even refuse to supply any more goods if payment is not made quickly.

Factoring of debts

Long-term finance

This is finance which is available for more than a year – and sometimes for very many years. Usually this money would be used to purchase long-term fixed assets, to update or expand the business, or to finance a takeover of another business. The main sources of long-term finance are as follows.

Bank loans

These are payable over a fixed period of time. The advantages and disadvantages of these have already been considered under 'External finance'.

Hire purchase

This allows a business to buy a non-current (fixed) asset over a long period of time with monthly payments which include an interest charge.
» The business does not have to find a large cash sum to purchase the asset.

However:
» A cash deposit is paid at the start of the period.
» Interest payments can be quite high.

Leasing

Leasing an asset allows the business to use the asset without having to purchase it. Some businesses decide to sell off some non-current (fixed) assets for cash and lease them back from a leasing company. This is called sale and leaseback.

» The business does not have to find a large cash sum to purchase the asset to start with.

» The care and maintenance of the asset are carried out by the leasing company.

However:

» The total cost of the leasing charges will be higher than purchasing the asset.

Issue of shares

Public limited companies can sell large numbers of shares to the public, raising large sums of money but can be expensive to organize and advertise. A rights issue of new shares is a common way to raise additional capital, allowing existing shareholders to buy new shares proportional to their current holding.

Long-term loans or debt finance

Loans differ from share capital in the following ways:

» Loan interest is paid before tax and is an expense.

» Loan interest must be paid every year, but dividends do not have to be paid if,

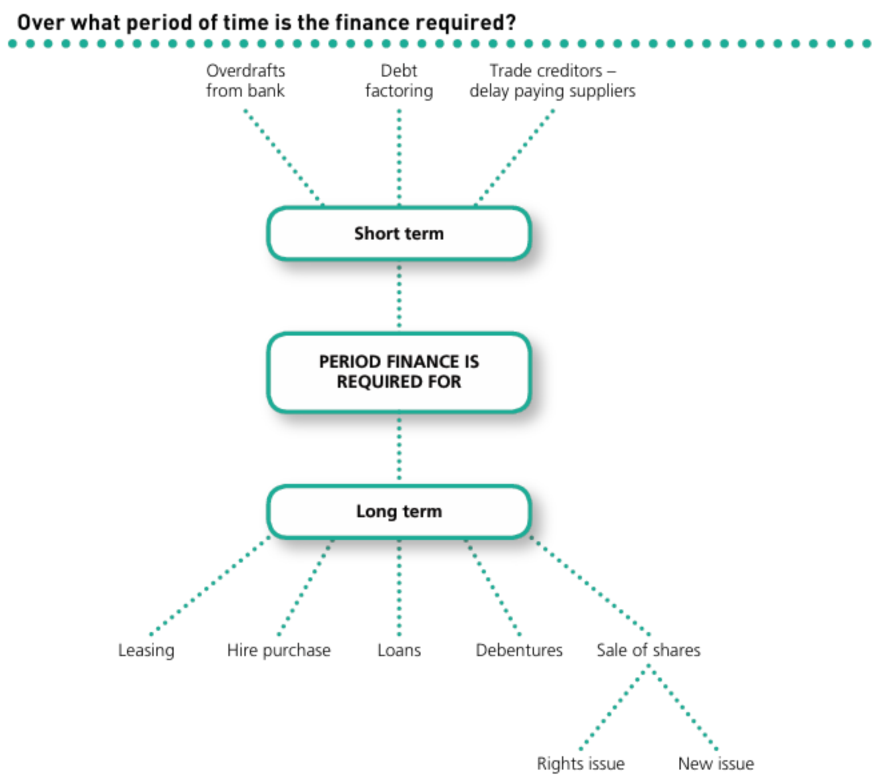
» Loans must be repaid, as they are not permanent capital.

» Loans are often 'secured' against assets.

The advantages and disadvantages of loans have already been mentioned under 'External finance'.

Sources of finance:

how businesses make the choice We now know the main sources of finance available to businesses. What factors do managers consider before deciding where to obtain finance from?



Purpose and time period

The general rule is to match the source of finance to the use that will be made of it.

» If the use is long term, for example, the purchase of a non-current asset, the source should be long term.

» If the use is short term, for example, the purchase of additional inventories to cover a busy period, the source should be short term.

Amount needed

Different sources will be used depending on the amount of money needed. A company would not go to the expense of arranging a new share issue if only $5000 of capital was needed for a short time period.

Legal form and size

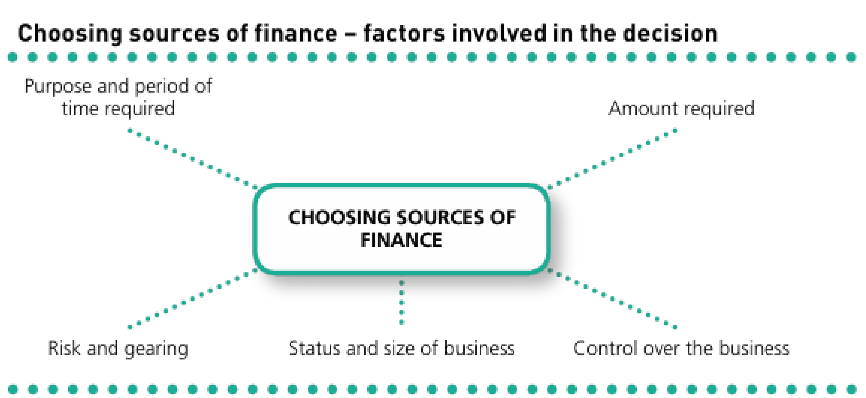
Companies, especially public limited companies, have a greater choice of sources of finance. Issuing shares or debentures is not an option for sole traders and partnerships. These businesses, if they have plans to expand, may have to depend on the savings of their owners – personal capital.

Control

Owners of a business may lose control of that business if they ask other people to invest in their firm. Owners may have to decide: what is more important – expanding the business or keeping control of it?

Risk and gearing – does the business already have loans?

Loan capital raises the gearing of a business, a measure of risk. A high gearing, over 50%, indicates a risky financing approach. High interest rates and low profits can lead to inability to pay all loans, putting the business's future at risk. Banks are generally reluctant to lend to highly geared businesses, forcing them to use alternative financing sources.



Will banks lend and shareholders invest?

A business owner, especially of a new start-up business, will increase the chances of obtaining loan finance if the following is available:

» A cash flow forecast which shows why the finance is needed and how it will be used.

» An income statement for the last time period – and a forecast one for the next. These should show the chances of the business making a profit in future.

» Details of existing loans and sources of finance being used.

» Evidence that 'security' (or collateral) is available to reduce the bank's risk if it lends.

» A business plan to explain clearly what the business hopes to achieve in the future and why the finance is important to these plans.

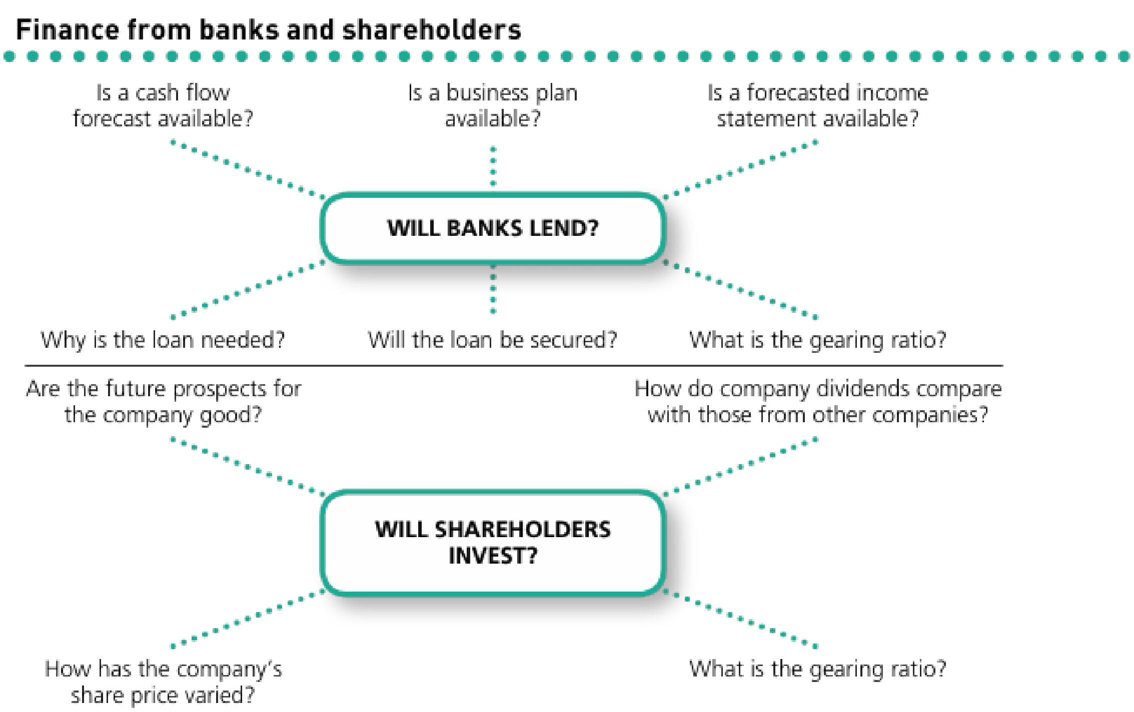
Shareholders are most likely to buy additional shares when:

» The company's share price has been increasing

» Dividends are high – or profits are rising so dividends might increase in the future

» Other companies do not seem such a good investment

» The company has a good reputation and has plans for future growth.



Chapter 23
Cash flow forecasting and working capital

Why cash is important to a business?

Cash flow refers to the flow of money into and out of a business over a specific time period, ensuring the availability of cash for spending on goods and services. Issues such as running out of cash, borrowing, or incurred bills can occur.

If a business has too little cash – or even runs out of it completely – it will face major problems,

such as:
» Being unable to pay workers, suppliers, landlord, government
» Production of goods and services will stop – workers will not work for no pay and suppliers will not supply goods if they are not paid
» The business may be forced into 'liquidation' – selling up everything it owns to pay its debts.

Definitions to learn

The **cash flow** of a business is the cash inflows and outflows over a period of time.

Definitions to learn

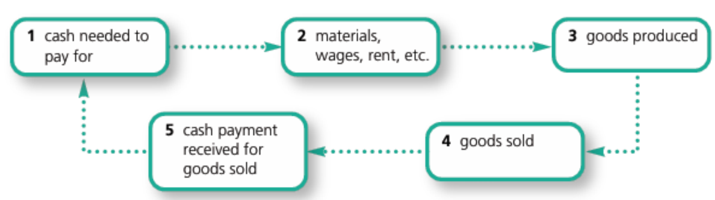
Cash inflows are the sums of money received by a business during a period of time.
Cash outflows are the sums of money paid out by a business during a period of time.

What is meant by cash flows?

How can cash flow into a business (**cash inflow**)? Here are five of the most common ways:
» The sale of products for cash.
» Payments made by debtors – debtors are customers who have already purchased products from the business but did not pay for them at the time.
» Borrowing money from an external source – this will lead to cash flowing into the business (it will have to be repaid eventually).
» The sale of assets of the business, for example, unwanted property.
» Investors, for example, shareholders in the case of companies, putting more money into the business. How can cash flow out of a business (**cash outflow**)?

Here are five of the most common ways:
» Purchasing goods or materials for cash.
» Paying wages, salaries and other expenses in cash
» Purchasing non-current (fixed) assets.
» Repaying loans.
» By paying creditors of the business – other firms which supplied items to the business but were not paid immediately.

Cash flow cycle



▲ The cash flow cycle

Definitions to learn

A **cash flow cycle** shows the stages between paying out cash for labour, materials, and so on, and receiving cash from the sale of goods.

The longer the time taken to complete these stages, the greater will be the firm's need for working capital and cash. The diagram also helps us to understand the importance of planning for cash f lows. What would happen in the following situations?

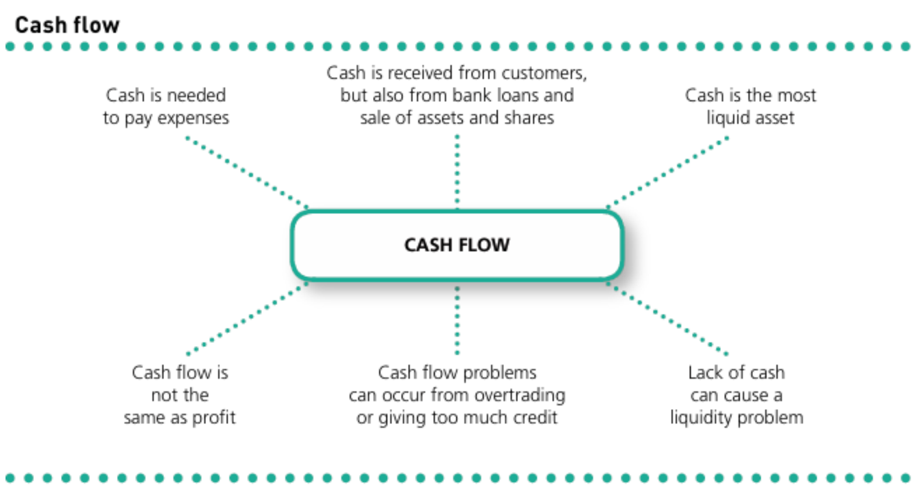
» If a business did not have enough cash at stage 1? Not enough materials and other requirements could be purchased and so output and sales would fall.

» If a business insisted on its customer paying cash at stage 4 because the business was short of money? It might lose the customer to a competitor who could offer credit.

» If a business had insufficient cash to pay its bills such as rent and electricity? It would be in a liquidity crisis and it might be forced out of business by its creditors.

What cash flow is not!

Cash flow is not the same as profit. This is an important distinction.



Definitions to learn

Profit is the surplus after total costs have been subtracted from revenue.

The importance of cash flow forecasts

A cash flow forecast can be used to tell the manager:

» How much cash is available for paying bills, repaying loans or for buying fixed assets
» How much cash the bank might need to lend to the business in order to avoid insolvency
» Whether the business is holding too much cash which could be put to a more profitable use.

Managers use cash flow forecasts to help them find out the future cash position of their business.

Uses of cash flow forecasts

Cash flow forecasts are useful in the following situations:

» Starting up a business
» Running an existing business
» Keeping the bank manager informed
» Managing cash flow.

Definitions to learn

A **cash flow forecast** is an estimate of future cash inflows and outflows of a business, usually on a month-by-month basis. This then shows the expected cash balance at the end of each month.

Starting up a business

A cash flow forecast is crucial for new business owners to understand the necessary cash for the first few months of operation, as it helps avoid costly expenses such as purchasing premises, hiring machinery, building inventory, and advertising and promotion costs.

Keeping the bank manager informed

Bank managers must assess a firm's cash flow forecast before lending money to businesses, determining the size, timing, duration, and repayment potential of loans or overdrafts. This is crucial for both new and existing businesses.

Definitions to learn

Net cash flow is the difference, each month, between inflows and outflows.

Closing cash (or **bank**) **balance** is the amount of cash held by the business at the end of each month. This becomes next month's opening cash balance.

Opening cash (or **bank**) **balance** is the amount of cash held by the business at the start of the month.

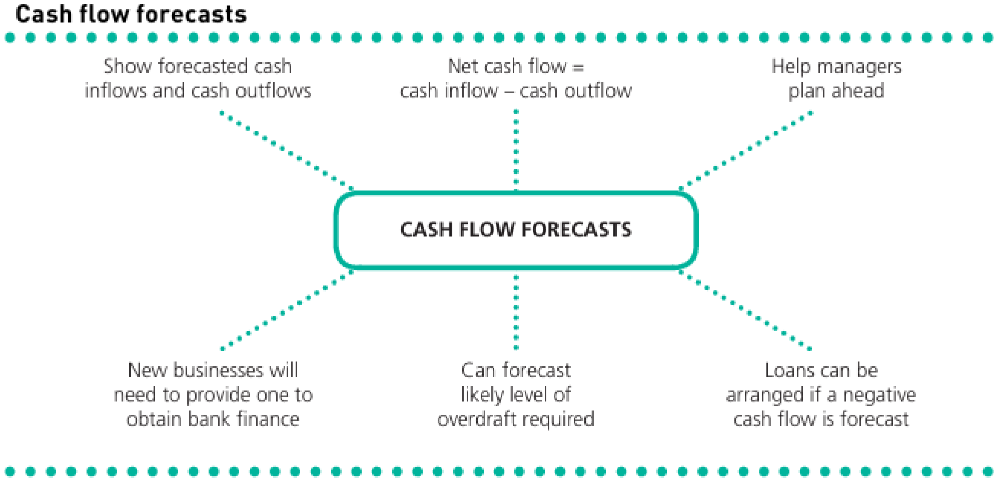
Managing an existing business

Cash forecasting is crucial for businesses, as they can run out of cash and require an overdraft due to expensive assets or sales decline. Borrowing money in advance is essential for the lowest interest rates. Poor business planning can lead to bank refusal or high interest rates, and if the business exceeds the overdraft limit, it could force closure.

Managing cash flow

Too much cash held in the bank account of a business means that this capital could be better used in other areas of the business. If it seems that the business is likely to have a very high bank balance, the accountant could decide to pay off loans to help reduce interest charges.

Cash flow forecasts



How a short-term cash flow problem might be overcome There are several ways in which a short-term cash flow problem could be overcome.

In the longer term, a business with cash flow difficulties will have to take other decisions to solve the problem. These could include the following:

» Attracting new investors, for example, by selling more company shares – but will this affect ownership of the business?
» Cutting costs and increasing efficiency – but will this be popular with employees and could product quality be affected?
» Developing new products that will attract more customers – this could take a long time and needs cash in the short term to pay for development.

Method of overcoming cash flow problem	How it works	Limitations
Increasing bank loans	Bank loans will inject more cash into the business	Interest must be paid – this will reduce profits The loans will have to be repaid eventually – a cash outflow
Delaying payments to suppliers	Cash outflows will decrease in the short term	Suppliers could refuse to supply Suppliers could offer lower discounts for late payments
Asking debtors to pay more quickly – or insisting on only 'cash sales'	Cash inflows will increase in the short term	Customers may purchase from another business that still offers them time to pay (trade credit)
Delay or cancel purchases of capital equipment	Cash outflows for purchase of equipment will decrease	The long-term efficiency of the business could decrease without up-to-date equipment

The concept and importance of working capital

The term **working capital** refers to the amount of capital which is readily available to a business. That is, working capital is the difference between resources in cash or readily convertible into cash and the short-term debts of the business.

$$\text{Working capital} = \text{Current assets} - \text{Current liabilities}$$

Definitions to learn

Working capital is the capital available to a business in the short term to pay for day-to-day expenses.

Working capital may be held in different forms:

» Cash is needed to pay day-to-day costs and buy inventories.
» The value of a firm's debtors is related to the volume of production and sales. To achieve higher sales there may be a need to offer additional credit facilities.
» The value of inventories is also a significant part of working capital. Not having enough inventories may cause production to stop. On the other hand, a very high inventory level may result in high opportunity costs.

Chapter 24

Income statements

What are accounts and why are they necessary?

The financial records of a business are called its **accounts**. They should be kept up to date and with great accuracy – this is the responsibility of the **accountants** working in the Finance department. At the end of each financial year, the accountant will produce the **final accounts** of the business.

Definitions to learn

Accounts are the financial records of a firm's transactions.
Accountants are the professionally qualified people who have responsibility for keeping accurate accounts and for producing the final accounts.
Final accounts are produced at the end of the financial year and give details of the profit or loss made over the year and the worth of the business.

Recording accounting transactions

In most businesses, there are so many transactions each year that it would be very time-consuming to record them all by hand in accounting books. This is one reason most organisations now use computers.

How a profit is made

Profit is an objective for most businesses. In simple terms, profit is calculated by:

$$\text{Profit} = \text{Revenue} - \text{Cost of making products}$$

The profit formula also suggests that this surplus can be increased by:

1. Increasing revenue by more than costs
2. Reducing the cost of making products
3. A combination of 1 and 2

Why profit is important to private sector businesses

Profit is important to private sector businesses for several reasons:

Why profit is important	Explanation
Reward for enterprise	Successful entrepreneurs have many important qualities and characteristics and profit gives them a reward for these.
Reward for risk taking	Entrepreneurs and other investors take considerable risks when they provide capital to a business – profits reward them for taking these risks by allowing payments to be made (for example, dividends to shareholders).
	These payments provide incentives: to business owners to try to make their business even more profitable; to investors to put more capital into profitable businesses.
Source of finance	Profits after payments to the owners (retained profits) are a very important source of finance for businesses – this allows for expansion (see Chapter 22).
Indicator of success	When some businesses are very profitable, other businesses or new entrepreneurs are given a signal that investment into producing similar goods or services would be profitable. If all businesses in an industry are making losses, this would not be a good signal to set up in that industry!

In social enterprises profit also has an important role to play. Social enterprises cannot usually survive unless they make a surplus from their operations, **but** profit is not their only objective. The managers of social enterprises will want to balance profit-making with other aims, such as protecting the environment and benefiting disadvantaged groups in society.

Difference between profit and cash

Do you recall from Chapter 23 that profit and cash are not necessarily the same?
Q: Why is it important to remember this distinction when looking at a business's final accounts?

A: Just because a business records a profit does not mean it has plenty of cash. In fact, it could have no cash at all! Attempt the following activity to confirm that you understand this important point.

Activity 24.1

Copy and complete the following table.

Business transaction	Profit/loss	Impact on cash
a Sells 5000 items for cash @ $2. Each item cost the business $1.50 but it has not yet paid its suppliers	$2500 (5000 items × $0.50)	
b Sells 25 000 items on credit @ $3. Pays cash to suppliers ($2 per item)		Outflow of $50 000 (sales on credit but cash paid for supplies)
c Sells 8000 items for cash @ $4. Suppliers paid in cash ($2 per item)	$16 000	

Main features of an income statement

Income statements (also known as profit and loss accounts) are important f inancial statements. They indicate to managers, business owners and other account users whether the business has made a profit or loss over a period of time.

If the business is making a profit, managers will want to ask themselves:
» Is it higher or lower than last year?
» If lower, why is profit falling?
» Is it higher or lower than other similar businesses?
» If lower, what can we do to become as profitable as other businesses?

If the business is making a loss, managers will want to ask themselves:
» Is this a short- or long-term problem?
» Are other similar businesses also making losses?
» What decisions can we take to turn losses into profits? You can begin to realise why income statements are so important.

Definitions to learn

An **income statement** is a financial statement that records the income of a business and all costs incurred to earn that income over a period of time (for example, one year). It is also known as a profit and loss account.
The **revenue** is the income to a business during a period of time from the sale of goods or services.

Revenue

This is the amount made by the business from the sales of its goods or services. It is calculated by multiplying price by the amount sold. For example, if the price = $10 and 1000 products are sold, then **revenue** = $10 000.

Cost of sales

Cost of sales is also sometimes known as cost of goods sold. It is the variable cost of production for the goods or services sold by a business. This includes the cost of the materials used in creating the good plus the direct labour costs of producing the good.

Definitions to learn

The **cost of sales** is the cost of producing or buying in the goods actually sold by the business during a time period.
A **gross profit** is made when revenue is greater than the cost of sales.

Gross profit

What information do income statements contain? Before we can answer this, we need to consider an important concept known as **gross profit** – which is profit calculated before fixed costs are considered.

$$\text{Gross profit} = \text{Revenue} - \text{Cost of sales}$$

It is important to note the following:
» Gross profit does not make any allowance for overhead costs or expenses.
» Cost of sales is not necessarily the same as the total value of goods bought by the business.

Income statement for XYZ Limited		The business/company name should be shown clearly
For the year ending 31/10/18	$000	The time period covered by the income statement must be shown
Revenue	450	This is the value of goods sold during the year. For example, 900 000 items @ 50 cents each
Cost of sales	270	This is the variable cost (materials and labour, for example) of making the goods sold. For example, 900 000 items costing 30 cents each
Gross profit	180	This is the profit made before expenses = $450 000 – $270 000

Definitions to learn
The **cost of sales** is the cost of producing or buying in the goods actually sold by the business during a time period.
A **gross profit** is made when revenue is greater than the cost of sales.

This section of the income statement is often referred to as the **trading account**. It shows the gross profit made from the normal trading activities of the business.

Definitions to learn
A **trading account** shows how the gross profit of a business is calculated.

Net profit (also known as 'profit')

Net profit is calculated by deducting all expenses and overheads of the business from gross profit. Unlike gross profit, net profit will also include any non-trading income, such as the rent from an apartment above a shop.

Depreciation is the fall in the value of a fixed asset over time. This is included as an annual expense of the business.

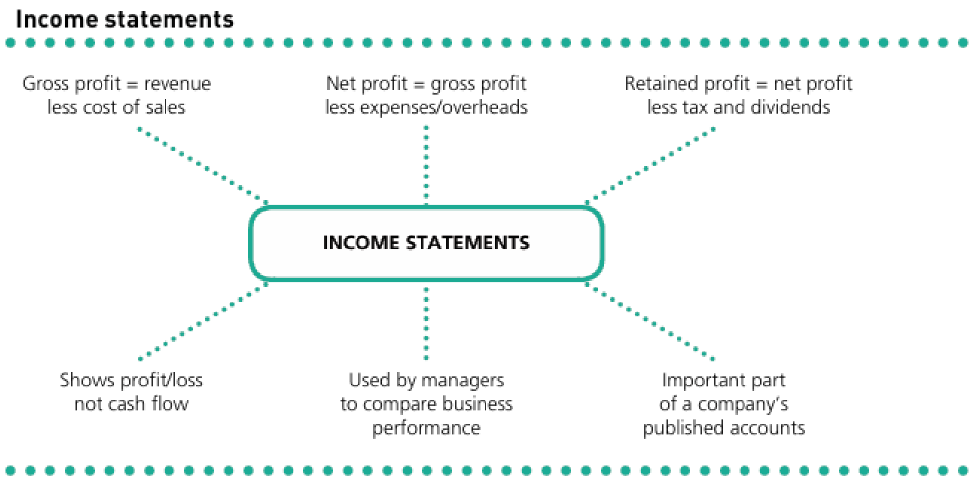
Definitions to learn
Net profit is the profit made by a business after all costs have been deducted from revenue. It is calculated by subtracting overhead costs from gross profits.
Depreciation is the fall in the value of a fixed asset over time.

Retained profit

The retained profit is the profit left, or reinvested back into the business, after all payments have been deducted.

The income statement for limited companies will also contain:
» Corporation tax paid on the company's net profits
» The dividends paid out to shareholders (in some years, dividends might be zero)
» The retained profits left after these two deductions
» Results from the previous year to allow for easy comparisons.

Definitions to learn
Retained profit is the net profit reinvested back into a company, after deducting tax and payments to owners, such as dividends.



Using income statements in decision making

Managers can use the structure of income statements to help them in making decisions based on profit calculations. If a manager has to choose which of two new products to launch, one way of making this decision is to construct two forecasted income statements.

Chapter 25

Statement of financial position

Business owners would be very interested to know how much their business is worth. This information, together with other details, is given on the **statement of financial position**.

Business statements of financial position follow exactly the same principles. They list and give a value to all of the **assets** and **liabilities** of the business. It is important to understand these terms before the layout of the statement of financial position is explained.

» Assets are valued items owned by a business, such as land, buildings, equipment, and vehicles. Non-current assets depreciate over time, while intangible assets like brand names and patents have value.

» Liabilities are business items owed, with non-current liabilities being long-term borrowings not repaid within a year and current liabilities being amounts owed within a year.

Definitions to learn

The **statement of financial position** shows the value of a business's assets and liabilities at a particular time.

Definitions to learn

Assets are those items of value which are owned by the business. They may be non-current (fixed) assets or (short-term) current assets.
Liabilities are debts owed by the business. They may be non-current (long-term) liabilities or (short-term) current liabilities.

Explanation of statement of financial position terms

» Non-current and current assets, current and non-current liabilities (see above).
» Total assets less total liabilities is always equal to total shareholders' funds or equity – otherwise the statement of financial position would not balance!

» Shareholders' equity (or shareholders' funds) is the total sum of money invested into the business by the owners of the company – the shareholders.

This money is invested in two ways:

• Share capital is the money put into the business when the shareholders bought newly issued shares.

• Reserves arise for a number of reasons. Profit and loss reserves are retained profits from current and previous years. This profit is owned by the shareholders but has not been paid out to them in the form of dividends.

> **Definitions to learn**
>
> **Non-current assets** are items owned by the business for more than one year.
>
> **Current assets** are owned by a business and used within one year.
>
> **Non-current liabilities** are long-term debts owed by the business, repaid over more than one year.
>
> **Current liabilities** are short-term debts owed by the business, repaid in less than one year.

Interpreting the statement of financial position data

» Shareholders can see if 'their' stake in the business has increased or fallen in value over the last 12 months by looking at the 'total equity' figures for two years.

» Shareholders can assess business expansion through non-current liabilities, retained profits, or share capital. If inventories or stocks were sold off, this is evident in the statement of financial position.

» Working capital can be calculated from statement of financial position data. This is a very important concept. It is also known as net current assets. It is calculated by the formula:

$$\text{Working capital} = \text{Current assets} - \text{Current liabilities}$$

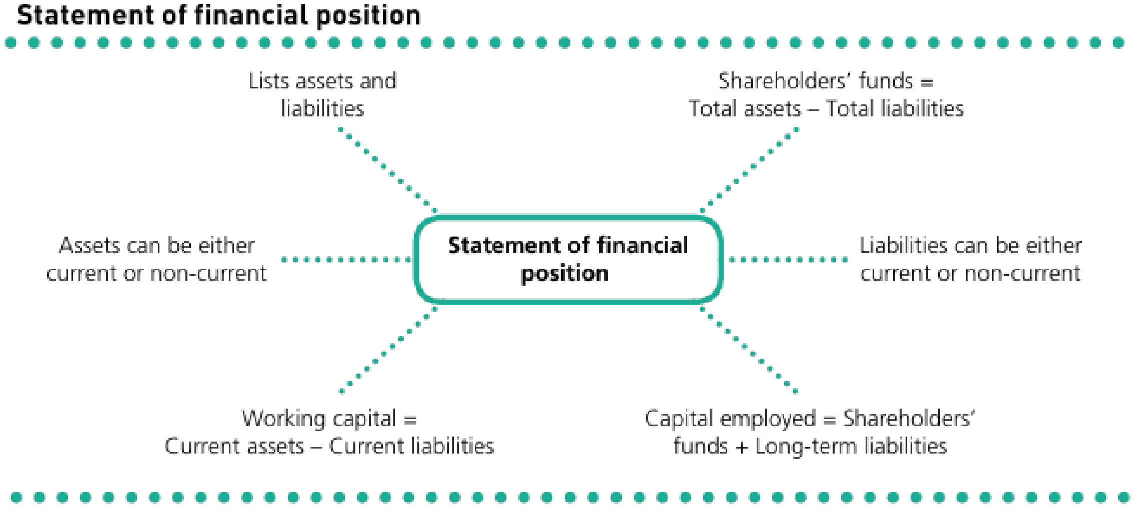
» No business can survive without working capital. It is used to pay short-term debts. If these debts cannot be paid because the business does not have enough working capital, the creditors could force the business to stop trading.

» Capital employed can also be calculated by using data from the statement of f inancial position. The following formula is used:

$$\text{Capital employed} = \text{Shareholders' funds} + \text{Non-current liabilities}$$

» The statement of financial position data can also be used to calculate ratios which are used to assess business performance.

Statement of financial position



Chapter 26
Analysis of accounts

The company accounts or financial statements we have studied contain a great deal of information. These published accounts of limited companies are made available to all those interested in the performance of the business. There are many stakeholders who will analyse company accounts.

Definitions to learn
Capital employed is shareholders' equity plus non-current liabilities and is the total long-term and permanent capital invested in a business.

Without 'analysis of accounts' it is often impossible to tell whether a business is:
» Performing better this year than last year
» Performing better than other businesses.

▲ It is impossible to tell which of these businesses is more profitable without analysing their accounts

There are many ratios which can be calculated from a set of accounts. This chapter concentrates on five of the most commonly used. These ratios are used to measure and compare profitability (or performance) and **liquidity** of a business.

Definitions to learn
Liquidity is the ability of a business to pay back its short-term debts.

The concept and importance of profitability
Profit is an amount of money the business has made after all costs have been taken off revenue. However, **profitability** is different to profit, although it is related. It is the measurement of the profit made relative to either:
» The value of sales achieved
» The capital invested in the business.

Definitions to learn
Profitability is the measurement of the profit made relative to either the value of sales achieved or the capital invested in the business.

Profitability is measured in percentage form. Profitability is therefore a measure of efficiency and can be used to compare the business's performance over a number of years and also to compare its performance with that of other businesses. It is important to:

» Investors when deciding which business to invest in

» Directors and managers of the business to assess if the business is becoming more or less successful over time.

Profitability ratios

Three commonly used profitability ratios are:

1. Return on capital employed (ROCE).

This is calculated by the formula:

$$\frac{Net\ profit}{Capital\ employed} \times 100$$

Profitability ratios – what do they tell us?

One profitability ratio result is not very useful. When a ratio result is compared with others, then some effective analysis can be done. Here are some examples taken from the same business:

Ratio results	Observation	Analysis
Gross profit margin: 2017 – 20% 2018 – 24%	This means that the gross profit on each \$1 of sales has increased.	The business is more successful at converting sales into profit. Either the price of goods has increased (by more than costs) or the cost of sales has fallen (but price has not been reduced at all or not by as much).
Net profit margin: 2017 – 14% 2018 – 12%	This means that the net profit on each \$1 of sales has fallen – even though gross profit margin has increased.	The business is less successful at converting sales into net profit. The overheads/fixed costs of the business must have increased significantly during the year – reducing the company's net profit compared to revenue.
Return on capital employed: 2017 – 10% 2018 – 6%	The profit made for each \$1 invested in the business has fallen.	This must be because either net profit has fallen or capital employed has increased. If capital employed has increased, this could mean that the managers of the business have invested more, hoping to make higher profit in future.

The concept and importance of liquidity

If a business cannot pay its suppliers for materials that are important to production or if the business cannot repay an overdraft when required to, it is said to be **illiquid**.

Definitions to learn

Illiquid means that assets are not easily convertible into cash.

1.Liquidity ratios

Two commonly used liquidity ratios are:

$$Current\ ratio = \frac{Current\ assets}{Current\ liabilities} \times 100$$

2. Acid test ratio

This is calculated by the formula

$$Acid\ test\ ratio = \frac{Current\ assets - Inventories}{Current\ liabilities} \times 100$$

Liquidity ratios – what can they tell us?

One liquidity ratio result is not very useful. When a ratio result is compared with others, then some effective analysis can be done. Here are some examples taken:

Ratio results	Observation	Analysis
Current ratio 1.0 – 2018 Current ratio 1.5 – 2017	The current ratio has fallen between 2017 and 2018.	This could be because the business has bought and used many more supplies, but not yet paid for them. It could also be because the business has used cash to pay for fixed assets. The business has low liquidity and needs to increase current assets or reduce current liabilities.
Current ratio 1.75 – 2018 Acid test ratio 0.5 – 2018	The current ratio is acceptable and much higher than the acid test ratio in 2018.	The acid test ratio might be too low – the business might be at risk of not being able to pay its short-term debts from its liquid assets – cash and accounts receivable (debtors). The great difference between the two results is because of a relatively high level of inventories.

Why and how accounts are used

Who uses the accounts of a business? Which groups would analyse a company's accounts, such as by calculating ratios? As it is only the accounts of public limited companies that have to be published, we shall concentrate on the uses and users of these.

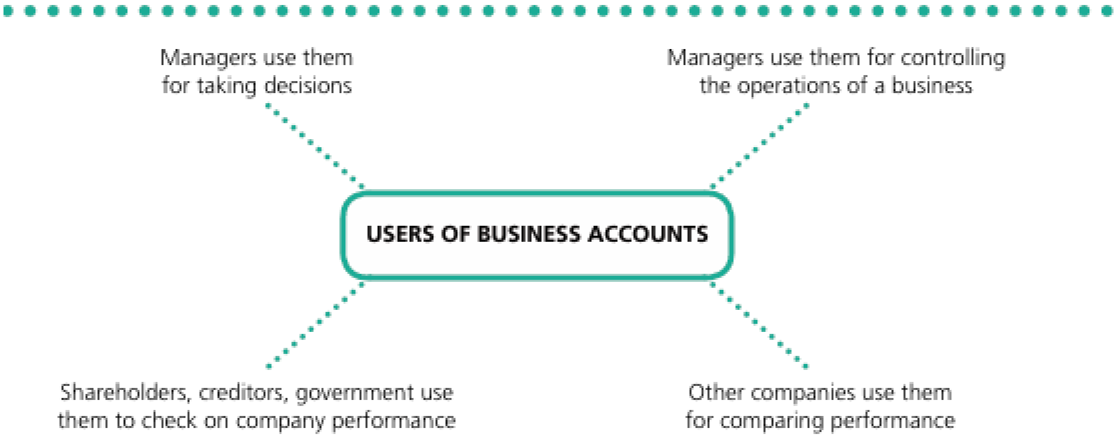
User of accounts	What they use the accounts for
Managers: they will be able to have much more detailed and frequent accounting information than any of the other groups	They will use the accounts to help them keep control over the performance of each product or division of the business. Managers will be able to identify which parts of the business are performing well or poorly. Accounting data will help in decision making, for example whether to expand the business, change price levels or close down a product or division that is not doing well.

User of accounts	What they use the accounts for
	Managers will calculate accounting ratios too. Ratios are very useful and a quick way for managers to compare their company's profit performance and liquidity. Ratio results may be compared with: • other years • other businesses. It is important to compare accounting ratios in these ways. One ratio result on its own means very little. Consider this example: Hurtwood Trading Co. Ltd return on capital employed 2018: 12%. Is this a good or a bad result? This question can only be answered by managers looking at past results and those of other companies. For example, here is some additional information: Hurtwood Trading Co. Ltd return on capital employed 2017: 5.8% Westbay Trading Co. Ltd return on capital employed 2018: 20%. Now the managers of Hurtwood Trading can make realistic comparisons. Their company is performing more effectively than in the previous year but it still needs to improve further to equal the performance and profitability of one of the company's closest rivals.
Shareholders: limited companies are owned by shareholders and they have a legal right to receive the published accounts each year	Shareholders – and potential investors – want to know, from the income statement, how big a profit or loss the company made. The profitability ratio results will be compared with last year's. The higher the profitability ratio results are, the more likely shareholders are to want to invest by buying more shares in the company. They will want to know, from the statement of financial position, if the business is worth more at the end of the year than it was at the beginning. They will also assess the liquidity of the business – they do not want to invest in a company with serious cash or liquidity problems.
Creditors: these are other businesses which have supplied goods to the company without yet receiving payment	The statement of financial position will indicate to creditors the total value of debts that the company has to pay back and the cash position of the company. Liquidity ratios, especially when compared with the previous year, will indicate the ability of the company to pay back all of its creditors on time. If these results suggest the company has a liquidity problem, suppliers may refuse to supply goods on credit.
Banks: these may have lent money to the company on a short- or long-term basis	They will use the accounts in a similar way to creditors. If the business seems to be at risk of becoming illiquid, it is unlikely that a bank will be willing to lend more.
Government	The government and the tax office will want to check on the profit tax paid by the company. If the company is making a loss, this might be bad news for the government's control of the whole economy, especially if it means that workers' jobs may be lost.
Workers and trade unions	Workers and trade unions will want to assess whether the future of the company is secure or not. In addition, if managers are saying that 'they cannot afford to give workers a pay rise' it would be useful for workers and unions to assess whether the profits of the company are increasing or not.
Other businesses – especially those in the same industry	The managers of other companies may be considering a bid to take over the company or they may just wish to compare the performance of the business with that of their own. Businesses will compare their performance and profitability with others in the same industry.

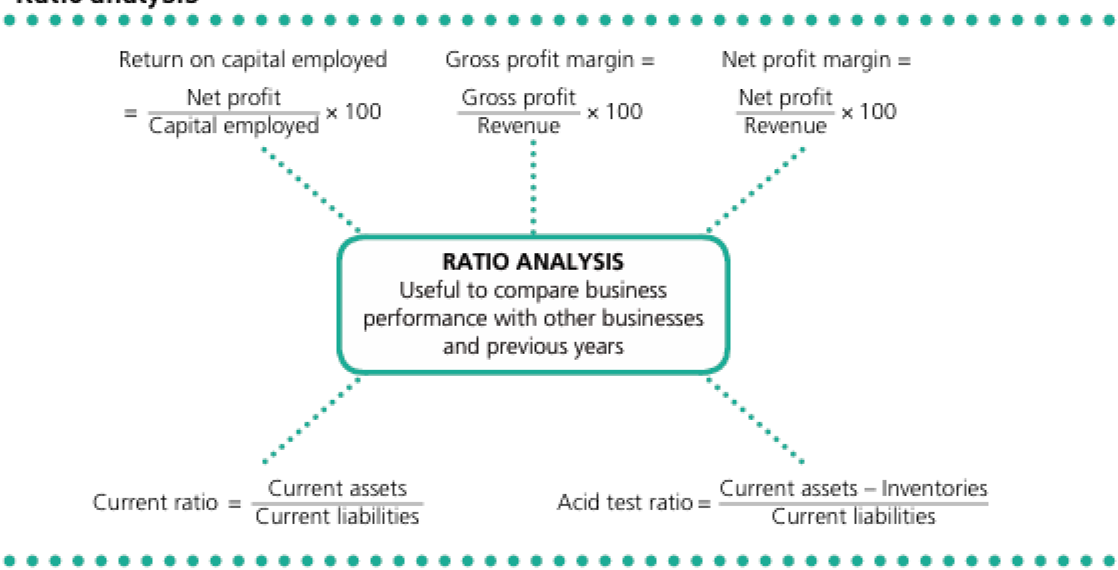
Limitations of using accounts and ratio analysis

» Managers will have access to all accounts data – but external users will only be able to use the published accounts, which contain only data required by law.
» Ratios are based on past accounting data and may not indicate how a business will perform in the future.
» Accounting data over time will be affected by inflation (rising prices), and comparisons between years may be misleading.
» Different companies may use slightly different accounting methods, for example in valuing their fixed assets. These different methods could lead to different ratio results, therefore making comparisons difficult.

Business accounts



Ratio analysis



Revision questions

1) Trucker is a public limited company that makes products such as tractors and construction vehicles. Table 1 gives selected information from its Balance Sheet for the last two years.

Table 1: Trucker's Balance Sheet as at 30 June

	$m			
	2009		2010	
Fixed Assets		200		225
Current Assets	150		180	
Current Liabilities	90		100	
Net Assets		260		305
Financed by:				
Long term Liabilities	200		220	
Shareholders' Funds	60		85	
Capital Employed		260		305

(a) What is meant by the term 'shareholders' funds'?
(b) Identify two examples of Trucker's current assets.
(c) Identify and explain two reasons why a business might have creditors.
(d) Identify and explain three possible reasons why Trucker's net assets increased in 2010.
(e) Can the success of Trucker's business be assessed just by analysing its Balance Sheet? Justify your answer.

2). Telefax is a business that manufactures a range of electronic products. Table 1 shows selected information from its latest Balance Sheet.

Table 1: Balance Sheet Telefax as at 30 June

	$m			
	2009		2010	
Fixed Assets		30		40
Current Assets	16		24	
Current Liabilities	16		20	
Net Assets		30		44
Financed by:				
Long term Liabilities	10		20	
Shareholders' Funds	20		24	
Capital Employed		30		44

(a) What is meant by the term 'fixed assets'?
(b) Identify two examples of Telefax's current liabilities.
(c) Identify and explain two reasons why most businesses have debtors.
(d) Identify and explain three reasons why Telefax's bank manager might want to see the accounts of the business.
(e) Do you think that the financial position of Telefax has improved in 2010? Justify your answer.

3). Celtic Springs, a public limited company, is a water bottling business. Its shareholders have been unhappy with the performance of the business and are threatening to take action at the next Annual General Meeting (AGM). Table 1 shows an extract from the company's latest Profit/Loss Account.

Table 1: Celtic Springs Profit/Loss Account 2011 ($m)

Sales revenue	?
Cost of sales	150
Gross profit	?
Overheads/expenses	70
Net profit	10

The accounts of the business also show that the capital employed by Celtic Springs was $650m.

(a) Calculate gross profit and sales revenue in 2011.

(b) Identify two functions of an Annual General Meeting.

(c) Identify and explain two ways Celtic Springs could reduce its cost of sales.

(d) Identify and explain three reasons why profit is important to a company such as Celtic Springs.

(e) Do you think that the shareholders of Celtic Springs are right to be unhappy with the company's performance? Justify your answer using the data provided.

(4). Durban Dragons is a big football club. Recently fewer people have been watching its matches and ticket revenue is falling. Some people say that ticket prices for matches are too high and should be reduced. The club has high fixed costs and needs to improve its cash flow. The club directors have been trying to gain sponsorship and a number of businesses are very interested.

(a) What is meant by 'cash flow'?

(b) Give two examples of fixed costs that a business like a football club would incur.

(c) Identify and explain two ways the cash flow of Durban Dragons could be improved.

(d) Identify and explain two reasons why businesses might want to sponsor football clubs like Durban Dragons.

(e) Do you think if Durban Dragons reduce ticket prices for matches this will increase revenue? Justify your answer.

5)Table 1 shows the Balance Sheet for company D at the end of 2010 and 2011.

Table 1: Company D Balance Sheet [$m]

	2010		2011	
Fixed Assets		500		600
Current Assets	600		650	
Current Liabilities	450		550	
Net Assets		650		700
Long-term Liabilities	350		350	
Shareholders' Funds	300		350	
Capital Employed		650		700

The accounts also showed that the net profit of company D was $80m in 2010 and $120m in 2011.

(a) What is meant by 'capital employed'?

(b) Calculate company D's current ratio in 2011.

(c) The directors are planning further expansion of the company. Identify and explain two benefits to company D of raising finance by selling more shares.

(d) Identify and explain a reason why the following stakeholders would be interested in using company D's accounts.

(e) Do you think the performance of company D in 2011 has improved? Justify your conclusion using the data

6) HTB is a public limited company. It manufactures a range of computers. HTB spends a lot of money on advertising as it is in a competitive market. The management believes that the product is the most important element in their marketing mix. To meet increasing demand HTB is looking to expand their business. It plans to raise extra capital by issuing more shares. The Finance Director has been looking at the data in Table 1.

Table 1: Selected financial data from HTB ($m)

	2011	2012
Sales	400	520
Net Profit	40	75
Long Term Liabilities	200	220
Capital Employed	400	500

(a) What is meant by 'public limited company'?
(b) Calculate the Return on Capital Employed for 2012.
(c) Identify and explain two reasons why shareholders might be interested in the accounts of HTB.
(d) Identify and explain three factors that HTB should consider before issuing more shares.
(e) Do you think that the product is the most important element of the marketing mix for HTB? Justify your answer.

7) Rapid Call is a private limited company. It manufactures a range of cell (mobile) phones. The demand for these is increasing. Its products have several special features that are not available from other phone manufacturers. It sells its products directly to retail shops. Rapid Call uses competitive pricing for all products. The Finance Director has been looking at the accounts. A summary is shown in Table 2. In 2011 the gross profit margin was 40%.

Table 2: Profit/Loss Account for Rapid Call for year ending 30 April 2012 ($000s)

Sales	450
Cost of Sales	300
Gross Profit	150
Overheads	95
Net Profit	55

(a) What is meant by 'private limited company'?
(b) Calculate the gross profit margin for the year ending 30 April 2012.
(c) Identify and explain two ways in which Rapid Call's Finance Director could use the information in Table 2.
(d) The Marketing Director is thinking about changing the channel of distribution. Identify and explain three factors that Rapid Call should consider when choosing a suitable channel of distribution.
(e) How important is increased competition in influencing the marketing strategy of Rapid Call? Justify your answer.

8) Bolton Hotel is a family-owned hotel. Most of its revenue is made in January and February. An extract of the hotel's accounts is shown in Table 1. The Managing Director said: 'I need to find ways to improve liquidity'. He is also concerned about the high level of staff turnover. He thinks that poor motivation might be the reason for many staff leaving their jobs.

Table 1: Extract from Bolton Hotel's balance sheet ($000s)

	2011	2012
Fixed assets	300	350
Current assets:	40	30
Stock	20	20
Debtors	10	8
Cash	10	2
Current liabilities	40	50

(a) What is meant by a 'balance sheet'?
(b) Calculate the acid test ratio for 2012.
(c) Identify and explain two problems for a business caused by many of its staff leaving.
(d) Identify and explain three suitable ways to improve motivation of staff at Bolton Hotel.
(e) Explain two ways to improve the liquidity of the hotel. Recommend which way the Managing Director should use. Justify your answer.

9)Belshire Books owns a number of shops. The Finance manager is worried about the financial position of the company. An extract of the accounts is shown in Table 1. Belshire Books is facing increased competition from online booksellers selling through the Internet.

Table 1: Extract from Belshire Books accounts ($000s)

	2011	2012
Net profit	50	30
Current assets	50	60
Current liabilities	50	50
Capital Employed	500	500

(a) What is meant by 'net profit'?
(b) Calculate the current ratio in 2012.
(c) Identify and explain two ways in which Belshire Books could improve profitability.
(d) Identify and explain two problems that competition from online (Internet) booksellers could cause for Belshire Books.
(e) Do you think that the Finance manager is right to be worried about the financial position of the business? Justify your answer.

10). Luxury Destinations owns three hotels in country X. The business spends a lot of money on staff training. The Finance Director is pleased with the financial position of the business. 'However, the appreciation of our country's currency and the Government's plan to increase taxes might cause problems to our business in the future' he said.

Table 1: Luxury Destinations financial information ($000s)

	2011	2012
Gross profit	195	220
Net profit	30	60
Fixed assets	300	350
Current assets	60	50
Current liabilities	60	75

(a) What is meant by 'appreciation of our country's currency'?
(b) Calculate the current ratio in 2012.
(c) Identify and explain two problems that an increase in taxes could cause for Luxury Destinations.
(d) Identify and explain three benefits for Luxury Destinations of training its employees.
(e) Do you think the Finance Director is right to be pleased with the financial position of the business? Justify your answer.