Unit 03 – Business finance

3.25 Source of finance

The need for funds

SHORT-TERM NEEDS

Finance is crucial for businesses to meet daily running costs, such as wages, raw materials, and utilities. **Short-term finance,** typically repaid within a year, is needed when revenue from sales may not cover all expenditure.

LONG-TERM NEEDS

Businesses often raise money and take much longer than one year to repay what is owed. This is called **long-term finance**. Some long-term finance comes from the owners. This is called **capital**.

START-UP CAPITAL

Funds are most needed when first setting up a business. This is because a lot of resources are needed before trading can begin. Some of these resources are 'one-off' items.

EXPANSION

Once a business is established, the owners often want to expand. They may want to:

■expand capacity to meet growing orders

■develop new products

■branch into overseas markets

■ diversify.

Businesses often need to raise finance to help fund their expansion plans; this is because expansion usually requires heavy expenditure.

Internal sources of finance

Sources of finance may be internal or external. Internal finance comes from inside the business and can only be used when the business is established. This is because new businesses are usually short of finance. There are three main internal sources of finance.

PERSONAL SAVINGS

When a business is set up the owners are usually required to contribute some finance. It would be rare for an entrepreneur to set up a business in which all the money needed to get started came from an external source.

RETAINED PROFIT

Retained profit is profit that has not been returned to the owners. It is retained by the business. It is an important source of finance for a business because it is cheap. There are no charges involved, such as interest, dividends or administration.

SELLING ASSETS

An established business may be able to sell some unwanted assets to raise finance.

External sources of finance

External finance comes from outside the business. There is a wide variety of both short-term and long-term external sources of finance. Short-term sources, where money is borrowed for less than one year, may be needed for the following reasons.

■Some businesses have seasonal trade.

■A manufacturer may need finance to pay for raw materials and wages to meet a large order.

■A firm might be short of money because it is waiting for a customer to pay.

■A business may need to meet emergency expenditure.

SOURCES OF FINANCE

Three main sources of short-term finance are outlined below.

BANK OVERDRAFT

This is a common source of finance for most businesses. A bank overdraft means a business can spend more money than it has in its account.

TRADE PAYABLES

Businesses often buy resources and pay for them later, usually within 30 to 90 days. This is called trade payables (or trade credit) and is a cheap way of raising finance. It means a business holds on to its cash for longer. However, it has its downsides:

■many suppliers encourage early payment by offering discounts

■the cost of goods is often higher if firms buy on credit

■delaying payment may upset suppliers.

CREDIT CARDS

Credit cards are popular because they are convenient, flexible and avoid interest charges if accounts are settled within the credit period. Executives can use them to meet expenses when travelling on company business.

LOAN CAPITAL

A loan is a fixed agreement between a business and the bank. The amount borrowed, and interest, must be repaid in regular instalments over a fixed period. Bank loans can be short-term or long-term sources of finance.

Unsecured bank loans

Some bank loans are unsecured. This means that the bank lends money without the security of having a claim on your assets if you do not pay it back. Therefore, if the business collapses, the bank might not get its money back.

Mortgages

A mortgage is a long-term loan and the borrower must use land or property as security. This means that if the borrower fails to make the repayments, the lender can repossess the property.

Debenture

Another form of loan is a debenture. Debenture holders are creditors of a company, not owners. Debenture holders are entitled to a fixed rate of return, but have no voting rights.

Hire purchase

Another type of loan is a hire purchase (HP) agreement. Businesses may use HP to buy tools, equipment, vehicles and machinery. The features of a HP agreement are:

■ the business usually makes a down payment the remaining fee is paid in monthly instalments

■ the goods bought do not legally belong to the buyer until the very last instalment has been paid

■ if the buyer falls behind with the repayments,

■ the goods can be repossessed

■ HP agreements can be short term or long term.

SHARE CAPITAL

A **rights issue** may be used to raise more share capital. This is where a company gives the existing shareholders the right to buy the new shares at a discount. The main advantage of selling shares to raise capital is that interest payments are avoided.

VENTURE CAPITAL

Venture capitalists are specialists in the provision of funds for small- and medium-sized businesses. They may invest in businesses after the initial start- up and often prefer technology companies with a high growth potential.

CROWD FUNDING

Crowd funding is a relatively new source of finance for businesses. It is similar to peer-to-peer funding (where banks are excluded, and individuals can lend money via the Internet to others without previous knowledge of them).

3. 26 Cash flow forecasting

The importance of cash

Cash is the most liquid of all business assets. Cash is the notes and coins a business keeps on the premises and any money it has in the bank. Businesses need cash for the following reasons.

CASH FLOW FORECASTING TO PAY SUPPLIERS, OVERHEADS AND EMPLOYEES

A business always needs cash to pay important bills. Suppliers have to be paid for the materials and components that have been purchased. A lot of purchases made from suppliers will have been made using trade payables (trade credit).

TO PREVENT BUSINESS FAILURE

If a business runs out of cash, it may become insolvent. This means that the business cannot pay its debts. This would usually result in the business closing down. Therefore, it is important that a business continually monitors and controls its cash flow. A business will have better control over its cash flow if it:

■keeps up-to-date records of financial transactions

■always plans ahead by producing accurate cash flow forecasts

■operates an efficient credit control system, which prevents slow or late payment.

The difference between cash and profit

It is important to recognise that cash and profit are different. At the end of a trading period, the value of profit will not be the same as the cash balance. Some of the reasons for this are outlined below.

■Some goods are sold on credit (trade payables). So, at the end of the period, some customers will still owe money. Therefore, profit is greater than cash. Similarly, a business may receive cash at the beginning of the trading period from credit sales made in the previous period. This would increase the cash balance, but not affect profit.

■Sometimes owners might put more cash into the business. This will increase the cash balance, but have no effect on the profit made. The effect will be the same if a business borrows some money.

■Purchases of fixed assets, such as machinery or equipment, will reduce cash balances, but have no effect on the profit a company makes. This is because the purchase of assets is not included for the purpose of calculating profit.

■The amount of cash at the end of the period will be different from profit because at the beginning of the year the cash balance is unlikely to be zero.

CASH INFLOWS AND OUTFLOWS

CASHFLOWS

The money entering a business is called a cash inflow. The expected cash inflows for Salah Motor Services (Cairo, Egypt) in June 2015 are shown in Figure 26.1.

CASH OUTFLOWS

The money going out of a business is called a cash outflow. Cash flows out of a business when payments are made. This might include wages, materials, utilities, machinery, rent and tax. Expected cash payments for Salah Motor Services in June 2015 are shown in Figure 26.1.

NET CASH FLOW

The difference between cash inflows and cash outflows is called the net cash flow. A business will hope that for most of the time the net cash flow is positive. This means that more cash flows in than flows out.

Cash flow forecasts

Most businesses produce a regular cash flow forecast. This is a financial document and shows the expected cash inflows and cash outflows over a future period. It also shows the **closing cash balance** at the end of each month.

Why are cash flow forecasts important

Businesses draw up cash flow forecasts to help control and monitor cash flow. What are the advantages of doing so?

IDENTIFYING CASH SHORTAGES

A forecast can help to identify in advance when a business might need to borrow cash. The forecast clearly shows how much cash is left at the end of each month. This will help to identify when, or if, a bank overdraft will be needed.

SUPPORTING APPLICATIONS FOR FUNDING

When trying to raise finance, lenders often insist that businesses support their applications with a cash flow forecast. This will help to show the future outlook for the business.

HELP WHEN PLANNING THE BUSINESS

Careful planning in business is important. It helps to clarify aims and improve performance. Producing a cash flow forecast is a key part of the planning process.

MONITORING CASH FLOW

A business should compare the predicted figures in the cash flow forecast with those that actually occur. By doing this, it can find out where problems have occurred. It could then try to investigate the reasons why the figures were different.

3. 27 Costs

Why does production generate costs?

The production of goods and provision of services uses up resources. For example, tyre production uses resources such as rubber, synthetic fabrics, steel bands, machinery, a factory, labour and energy.

COSTS

distribution and administration costs. Also, if the business has borrowed any money, there will be interest to pay on the loan.

FIXED COSTS

Some production costs remain the same whatever the level of output. These are called fixed costs. Examples of fixed costs include rent, business rates, advertising, insurance premiums, interest payments and research and development costs. These costs will not increase even if a firm produces more output.

VARIABLE COSTS

Production costs that change when the level of output changes are called variable costs. If a firm produces more output, variable costs will increase. Similarly, if output levels are cut, variable costs will fall.

Total costs

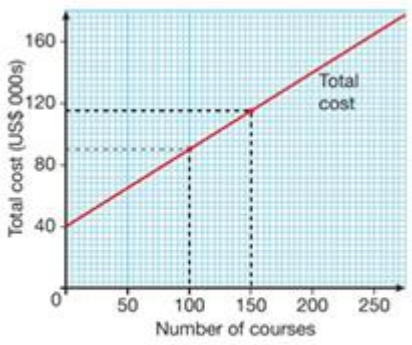
The cost to a firm of producing all output over a period is called total cost. Total cost (TC) can be calculated by adding fixed costs (FC) and variable costs (VC) together.

Total cost = Fixed costs + Variable costs

If Millhouse Training provides places for 100 training courses, total costs will be:

TC = US$40 000 + (100 × US$500)
= US$40 000 + US$50 000
= US$90 000

The total cost graph in Figure 27.3 shows that total cost increases from US$90 000 to US$115 000 when the number of courses provided rises from 100 to 150.



▲ Figure 27.3 Total costs for Frampton Training

AVERAGE COSTS

The average cost (AC) of production is the cost of producing a single unit of output. The formula for calculating average cost is given by:

$$\text{Average cost} = \frac{\text{Total cost}}{\text{Quantity produced}}$$

TOTAL REVENUE

The amount of money a firm receives from selling its output is called total revenue. Total revenue (TR) can be calculated by multiplying the price of each unit by the number of units sold:

Total revenue = Price x Quantity

CALCULATING PROFIT

One of the main reasons why firms calculate their costs and revenue is to work out profit or loss. Profit is the difference between total revenue and total costs.

Profit = Total revenue - Total cost

3.28 – break – even analysis

The concept of break even

A business will break even if its total costs (TC) and total revenue (TR) are exactly the same. This is called the break-even point. At this point, the business does not make a profit or a loss.

Calculating the break-even point

To calculate the break-even point, the following information is needed:

■fixed cost

■variable cost per unit

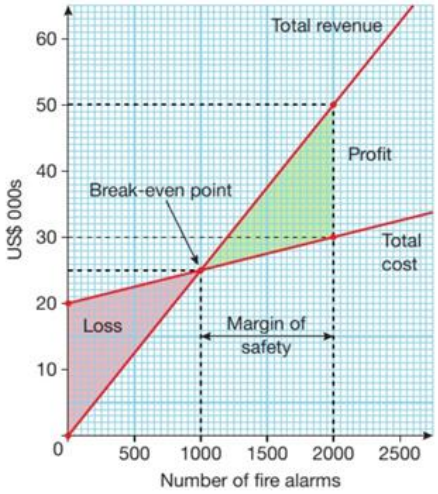
■selling price per unit.

The following formula can be used to calculate the break-even point:

$$\text{Break-even point} = \frac{\text{Fix cost}}{\text{Selling price} - \text{Variable cost per unit}}$$

Break – even chart

The break-even point can be shown on a graph. The break-even chart in Figure 28.1 shows total cost and total revenue for Ed Winchester's business in the previous example. Output is measured on the horizontal axis and revenue; costs and profit are measured on the vertical axis. What does the break-even chart show?



▲ Figure 28.1 Break-even chart for Ed Winchester

- The break-even point is where total cost and total revenue meet or intersect. In this example, the business breaks even when 1000 fire alarms are fitted. At this point, total cost and total revenue are both US$25000.
- At any level of output below the break-even point the business makes a loss.
- At any level of output above the break-even point the business makes a profit.
- If Ed Winchester fits 2000 alarms, the margin of safety is 1000 units. This is the range of output over which the business can make a profit (the difference between current output and the break-even level of output).
- Some break-even charts show fixed cost. In this example, a horizontal line at US$20000 would show fixed cost.

CONSTRUCTING A BREAK-EVEN CHART

Following the steps below will guide you through drawing a break-even chart. Nanjing Holdings assembles circuit boards to go inside electronic devices. Fixed costs are US$10000, variable costs are US$10 per circuit board and the assembled boards are sold for US$20 each.

Step 1: It is useful to know the break-even point before constructing the chart. This helps to check that your chart is correct. Calculate the break-even point using the formula given earlier. In this example, the break-even point is 1000 units (US$10000+ US$20 - US$10).

Step 2: Since both total cost and total revenue are straight lines, two sets of points (or co-ordinates) on the graph are needed to construct the lines. It is necessary to choose two levels of output and work out the total cost and total revenue at each level.

Choosing 0 as one level makes the calculations easier. If output is 0, TC will be US$10000 (remember that fixed costs are still incurred even when nothing is produced).

When output is 0, TR will also be 0 (there are no sales if nothing is produced). When choosing the second level of output, choose a value that is double the break-even point. This means the break-even point will appear right in the middle of the chart. Therefore, the second level of output will be 2000 (2 x 1000).

When output is 2000, TC = US$10000+ (US$10 x 2000) = US$30000. When output is 2000, TR = US$20 x 2000 = US$40000.

▼ Table 28.1 Total cost and revenue

OUTPUT	TC	TR
0	US$10 000	US$0
2000	US$30 000	US$40 000

Step 3: The values shown in the table represent two sets of co-ordinates, which can be used to plot TC and TR for the break-even chart.

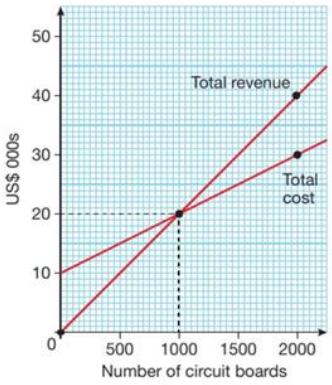
Output is measured on the horizontal axis and goes up to 2000.

Costs, revenue and profit are measured on the vertical axis and go up to US$40000.

TC can be drawn by placing the co-ordinates (0, US$20000) and (2000, US$30000) on the chart and joining them with a straight line.

TR can be drawn by placing the co-ordinates (0,0) and (2000, US$40000). The chart is shown in Figure 28.3.

The values for TC and TR at each level of output are summarised in Table 28.1.



▲ Figure 28.3 Break-even chart for Nanjing Holdings

EFFECT OF CHANGES IN PRICE AND COSTS ON THE BREAK-EVEN CHART

The break-even chart can be used to show the effects on the break-even point when there are changes in costs and price.

■If price is higher, TR will be steeper and the break-even point will shift to the left. This is shown in Figure 28.4(a).

■If price is lower, the TR will be flatter and the break-even point will shift to the right.

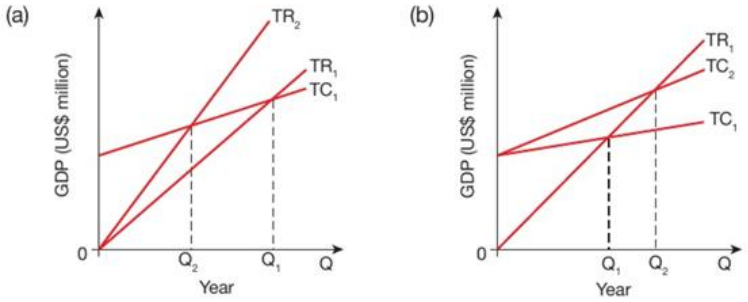
■If FC is higher, TC will move upward with the steepness unchanged and the break-even point will shift to the right.

■If FC is lower, TC will move downward with the steepness unchanged and the break-even point will shift to the left.

■If VC is higher, TC will be steeper and the break-even point will shift to the right. This is shown in Figure 28.4(b).

■If VC is lower, TC will be flatter and the break-even point will shift to the left.

▶ Figure 28.4 Effect of changes in price and variable cost on the break-even point



The limitations of a break – even chart

A break-even chart shows:

- how much output a business has to produce in order to break even
- the costs, revenue and profit at different levels of output
- the margin of safety.

However, the chart does have some limitations.

- The TC and TR are shown as straight lines. In practice, they may not be straight lines. For example, a business may have to offer discounts on large orders, so total revenues fall at high outputs. In this case, the total revenue line would rise and then eventually fall. A business can lower costs by bulk buying. So costs may fall at high outputs and total cost will be curved.
- It is assumed that all output is sold and no stocks are held. Many businesses hold stocks of finished goods to be able to cope with changes in demand. There are also times when firms cannot sell what they produce and choose to stockpile their output to avoid laying off staff.
- The accuracy of the break-even chart depends on the quality and accuracy of the data used to construct total cost and total revenue. If the data is poor and inaccurate, the conclusions drawn on the basis of the data will be wrong

3.29 Statement of comprehensive income

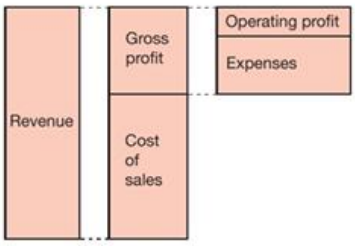
The purpose of a statement of comprehensive income

Businesses use the **statement of comprehensive income** to calculate the profit at the end of the financial year. A business normally calculates its profit using two steps. First, it calculates g**ross profit.** This is the profit made before expenses or overheads are subtracted. It is found by calculating:

Gross profit = revenue – cost of sales

Then it calculates operating profit. This is profit after expenses and is found by:

Operating profit = gross profit – expenses



Retained and distributed profit

The profit after tax can be **distributed profit or retained profit**. Some of the profit is likely to be distributed to the owners of the business. For example, limited companies may return some of the profit to shareholders. They are paid a **dividend**.

The statement of comprehensive income

The statement of comprehensive income shows the income and expenses of a business during the financial year. Table 29.2 shows the statement of comprehensive income for Walnut Soaps, a manufacturer of soap products and other toiletries.

▶ Table 29.2 Walnut Soaps statement of comprehensive income, year ending 31 May 2016

	2016 US$000	2015 US$000
Revenue	5400	4900
Cost of sales	3500	3100
Gross profit	**1900**	**1800**
Administration expenses	750	700
Other operating expenses	160	150
Operating profit	**990**	**950**
Finance costs	100	100
Profit for the year	**890**	**850**
Taxation	160	150
Profit for the year after taxation	**730**	**700**

REVENUE

Revenue is the money the business receives from selling goods and services. Revenue must not include VAT. This is because VAT does not belong to the business. The revenue for Walnut Soaps in 2016 was US$5400000.

COST OF SALES

For a manufacturer, cost of sales would include costs such as raw materials and the wages of factory workers. For a retailer, the cost of sales would be the cost of buying inventory (stock) for resale.

GROSS PROFIT

Gross profit is calculated when the cost of sales is subtracted from the revenue. This is the profit made before the subtraction of general expenses or overheads.

ADMINISTRATIVE EXPENSES

Administrative expenses are the general overheads or expenses of the business.

OTHER OPERATING EXPENSES

Any expenses not included in administrative expenses above may be called other operating expenses.

SELLING EXPENSES

A business may incur a range of expenses that are directly related to the selling of its products.

OPERATING PROFIT

If the administrative costs and other operating expenses are subtracted from gross profit we get the operating profit. The operating profit is the profit generated from the firm's main activities.

FINANCE COSTS

If a business borrows money it will have to pay interest to the lender. The amount paid will be entered in the income statement as a finance cost.

PROFIT FOR THE YEAR

If the cost of finance is subtracted from the operating profit, the profit for the year is determined. This is the profit before taxation (sometimes called net profit before tax).

PROFIT FOR THE YEAR AFTER TAX

This is the amount of money that is left over after all expenses, including taxation, have been subtracted from revenue. It is often referred to as the 'bottom line'. The money belongs to the owners of the business. In the case of a limited company, it belongs to the shareholders.

How might the statement of comprehensive income be used in decision marking

The statement of comprehensive income shows business owners and managers the amount of profit made by a business in a financial year.

INVESTMENT DECISIONS

A business might use the statement of comprehensive income to decide how much money to invest in the business.

COST ANALYSIS

The statement of comprehensive income will show what has happened to costs during the year. It might show, for example, that the cost of sales has increased sharply. As a result, a business can identify reasons for this and take measures to bring costs under control.

BASIS FOR FUTURE FORECASTS

Many businesses like to forecast the future performance of a business. Most public limited companies are expected to give shareholders some idea of what earnings to expect in the future. Businesses can therefore use the statement of comprehensive income as a basis on which to make forecasts.

MAKING COMPARISONS

Investors may use the statement of comprehensive income when deciding where to invest their funds. For example, if a financial institution was looking to invest some money in the motor car industry, it might look at the statements of different car manufacturers to help decide which one looks the most attractive.

The nature and importance of profit

Profit is the driving force in most businesses. There are few, if any, which attach no importance to profit, the exceptions perhaps being charities. Profit has a number of functions. .

Economists often refer to **normal profit**. This is the minimum financial reward an entrepreneur must receive in order maintain interest in a business. If a business does not earn this amount, an owner will pull out.

3. 30 – Statements of financial position

What is statement of financial position

Most businesses produce a **statement of financial position** at the end of the financial year. A statement of financial position is like a photograph of a firm's financial position at a particular point in time. It provides a summary of a firm's **assets, liabilities and capital**. It is also commonly known as a balance sheet.

■Assets are the resources owned by a business.

■Liabilities are the debts of the business, that is, what it owes to others. Liabilities are a source of funds for a business. They might be short term, such as an overdraft, or long term, such as a mortgage.

■Capital is the money put into the business by the owners. For limited companies this will be share capital. It is used to buy assets.

Features of a statement of financial position

The statement of financial position for Dingwall Building Supplies is shown in Table 30.2. The company operates a large store, which serves builders and other traders in the construction industry. The presentation of these statements may vary between different businesses.

NON-CURRENT ASSETS

Details of a firm's non-current assets are given at the top of the statement of financial position. Non-current assets are those that last for more than one year. They are the most productive resources of a business.

▶ Table 30.2 Dingwall Building Supplies statement of financial position, 31 December 3015

	US$000
Non-current assets	
Property	340
Fixtures and fittings	100
	440
Current assets	
Inventories	150
Trade receivables	78
Cash	56
	284
Current liabilities	
Trade payables	112
Taxation	12
	124
Net current assets	160
Non-current liabilities	
Mortgage	(60)
Net assets	540
Shareholders' equity	
Share capital	100
Retained profit	395
Other reserves	45
Capital employed	540

CURRENT ASSETS

Current assets are assets that will be changed into cash within one year. They are liquid assets. The liquidity of an asset is how easily and how quickly it can be changed into cash.

NET CURRENT ASSETS

Dingwall Building Supplies has $160,000 net current assets, calculated by subtracting current liabilities from current assets. This figure indicates the business's working capital, which is essential for cash flow management and meeting running costs.

NON-CURRENT LIABILITIES

Any money owed where repayment is not due for more than one year is called a **non-current liability**.

NET ASSETS

Net assets are the total at the bottom of the first part of the statement of financial position. It is the value of all assets less the value of all liabilities. To calculate net assets, add net current assets to non-current assets and then subtract non-current liabilities.

SHAREHOLDERS' EQUITY

The bottom section of the statement of financial position shows the capital of the business. This is all the money that is owed to the owners. It may also be called shareholders' funds or capital and reserves.

Interpreting the statement of financial position

A statement of financial position will show the financial position of a business at a given point in time and can be used to evaluate its performance and potential. It shows the:

■value of all business assets, capital and liabilities

■asset structure of a business, which means how the money raised by the business has been spent on different types of asset

■capital structure of a business, which is an analysis of the different types of funding the business has used

■value of net current assets, which is how much working capital a business has - indicating whether a business has enough liquid resources to pay its immediate bills.

2.31 – Ratio analysis

What is ratio analysis

It is possible to look at a statement of financial position and the statement of comprehensive income and to draw some conclusions about the financial position of a business. However, a more precise way is to use ratio analysis. This involves taking key figures from the accounts and calculating financial ratios. There are different types of financial ratios. Two groups that will be examined in this chapter are below.

■Profitability ratios measure the performance of the business and focus on profit, revenue and the amount invested in the business.

■Liquidity ratios measure how easily a business can pay its short-term debts, such as wages or suppliers.

Gross profit mergin

Table 31.3 shows some financial information that has been taken from the accounts of Ecohomes, a builder of environmentally friendly homes in Sweden. The information will be used in this chapter to calculate a number of useful ratios.

The gross profit margin shows the gross profit made on sales revenue. It is calculated using the following formula:

$$\text{Gross profit margin} = \frac{\text{Gross profit}}{\text{Revenue}} \times 100$$

▶ Table 31.3 Extracts from the accounts of Ecohomes, 2016

	2016 US$000	2015 US$000
Revenue	23 500	18 400
Cost of sales	12 500	10 100
Gross profit	11 000	8300
Operating profit	4600	3200
Current assets	13 600	11 900
Inventories	4900	5000
Current liabilities	8700	7800
Capital employed	20 000	18 000

Operating profit mergin

The operating profit margin helps to measure how well a business controls its expenses and cost of sales. If the difference between the gross profit margin and the operating profit margin is small, this suggests that expenses are low. The operating profit margin can be calculated by:

$$\text{Operating profit margin} = \frac{\text{Operating profit}}{\text{Revenue}} \times 100$$

Mark – up

Some businesses are interested in the profit made per item sold. This is called the mark-up and is calculated by:

$$\text{Mark-up} = \frac{\text{Profit per item}}{\text{Cost per item}} \times 100$$

Concepts and importance of liquidity

Liquidity is a very important issue for businesses. Liquidity refers to the ease and speed with which assets can be converted into cash. Non-current assets, such as property, plant, machinery and tools are not liquid assets. This is because they cannot be converted into cash very quickly.

CURRENT RATIO

The current ratio is a liquidity ratio and focuses on current assets and current liabilities. It is calculated using the formula:

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

ACID TEST RATIO

The acid test ratio is a more severe test of liquidity. This is because inventories are not treated as liquid resources. It is not certain that inventories will be sold. Therefore, they are excluded from current assets when calculating this ratio.

$$\text{Acid test ratio} = \frac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}}$$

Returned on capital employed

One of the most important profitability ratios is the return on capital employed (ROCE). It compares the profit (return) made by the business with the amount of money invested (its capital). The advantage of this ratio is that it links profit to the size of the business. ROCE can be calculated using the formula:

$$\text{ROCE} = \frac{\text{Operating profit}}{\text{Capital employed}} \times 100$$

Using ratio to make comparisons

Ratios can be used to assess the performance and the liquidity of a business at a particular point in time. They can also be used to monitor the progress of a business over time. The statement of comprehensive income and, the

statement of financial position, both show the figures for the current financial year and the previous financial year. This means that ratios can be calculated and compared immediately.

3. 32 the use of financial documents

Using financial documents to assess the performance of a business

MANAGERS AND EMPLOYEES

Managers will want to assess the performance of the company. The profit made by the business will be a reflection of their own performance.

OWNERS AND SHAREHOLDERS

Owners of small businesses will obviously be interested in the performance and the financial position of the business.

Shareholders in limited companies will also be interested in the performance of the business. They may look at the size of dividends. They may use ratio analysis to see how their investment is performing and make comparisons with other companies in which they could invest.

EXTERNAL STAKEHOLDERS

Banks and suppliers use financial information to assess a business's ability to repay loans, including working capital and debts. They also look at trading history to identify trends. Suppliers assess creditworthiness before granting trade credit, using accounts to evaluate new customers' risk.

Using financial documents to inform decision making

FUNDING DECISIONS

Access to relevant financial information can help to predict when more money will be needed by a business.

REDUCING COSTS

A business might use the statement of comprehensive income to analyse costs. If the gross profit margin is rising and the operating profit margin is falling, this would suggest that business expenses are increasing.

INCREASING PROFITABILITY

It may be possible to use the accounts to help find ways of making more profit.

INVESTMENT DECISIONS

Investment decisions are risky and uncertain because a business can never know for sure whether an investment project will generate returns in the future. The future is very difficult to predict.

Other uses of financial documents

GOVERNMENT

Many governments gather business and financial information. This is made available to the public. Some of the data is taken from accounts. The government uses the information to monitor the progress of the economy and help evaluate the success of its economic policies. People doing research may also use the information.

COMPETITORS

Limited company accounts are available to the public. Therefore, competitors can analyse them to make comparisons. Also, if a competitor is thinking about a takeover, it can use the information to help make a decision.

THE MEDIA

Television, online media companies and radio often produce reports on business and commerce. There are also specialists that focus on business information, for example, the Financial Times newspaper in the UK.

TAX AUTHORITIES

The tax authorities may require details of income when working out how much tax businesses and their owners must pay. Accounts can be used to provide details of income.

AUDITORS

Every year, the accounts of limited companies have to be checked by an independent firm of accountants and registered auditors. The process of checking the accuracy of accounts is called auditing.

REGISTRAR OF COMPANIES

In many countries, limited companies have to register with a registrar of companies. One of the conditions of registration is that they submit a copy of their final accounts every year. These accounts are available to the general public.