Business Management

H

N5

Management of People and Finance

3.2 – Finance

Learner's Notes

Introduction

In this topic you will find out about the following things.

Sources of finance

- *APPROPRIATE TO:*
  - *Sole Trader* [N5]
  - *Partnerships* [N5]
  - *Private Limited Companies* [N5]
  - *Public Limited Companies* [H]
  - *Public Sector Businesses*
  - *Third Sector Businesses*

Cash budgeting

- *INTERPRETATION OF CASH BUDGETS*
- *CASH FLOW ISSUES*
- *CASH FLOW ISSUE SOLUTIONS*

Break even

- *TYPES OF COSTS* [N5]
- *PROFIT* [N5]
- *BREAK-EVEN POINT* [N5]

Financial Statements

- *TRADING AND PROFIT AND LOSS ACCOUNTS*
- *BALANCE SHEETS* [H]

Ratio Analysis

- *PROFITABILITY RATIOS* [H]
- *LIQUIDITY RATIOS* [H]
- *EFFICIENCY RATIOS* [H]
- *LIMITATIONS OF RATIOS* [H]

Technology

- *ROLE OF TECHNOLOGY IN MANAGING FINANCE*

[N5] *– N5 ONLY*

[H] *– HIGHER ONLY*

THE ROLE OF FINANCE

*The role of **FINANCE** in a business is to make sure that a business has enough **CASH** to keep going and to produce **FINANCIAL DOCUMENTS** that will help it to plan and record its' financial performance.*

The main activities that are involved in this work by Finance staff are as follows.

- *RAISING FINANCE FOR BUSINESS ACTIVITIES*
- *DEALING WITH PAYMENTS RECEIVED*
- *PAYING FOR BUSINESS ACTIVITIES*
- *MANAGING CASHFLOW*
- *PREPARING FINAL ACCOUNTS*
- *CONDUCTING RATIO ANALYSIS*
- *BREAKEVEN ANALYSIS*

This work by the Finance staff is very important to any kind of business in an economy (ie PRIVATE, PUBLIC or THIRD sector), because if it is done properly then it can bring the following benefits.

1 IMPROVED BUSINESS PERFORMANCE

This work by the Finance Department is very important to a business, because if it is done properly then it can bring the following benefits.

- *INCREASE IN MONEY AVAILABLE FOR MARKETING, HRM AND OPERATIONS ACTIVITIES*
- *BETTER BUSINESS PERFORMANCE (from effective marketing, HRM and operations activities)*
- *POSITIVE BUSINESS IMAGE (from effective marketing, HRM and operations activities)*
- *INCREASED CONSUMER SATISFACTION (from effective marketing, HRM and operations activities)*
- *INCREASED USE OF THE BUSINESS BY CONSUMERS (CONSUMER LOYALTY)*

2 PREVENTS BUSINESS FAILURE

If a business runs out of money for paying bills and supporting the activities of Marketing, Operation and HRM, then it will have to close and will have **FAILED**. The following things will then happen to end the business.

People owed money by the business go to court to try and get their money back.

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The court puts the business that cannot pay bills into **ADMINISTRATION** (the legal process of the business trying to get money to pay those owed). When this happens, the court can put an **ADMINISTRATOR** in charge of the business instead of the normal management.

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The administrator will try to change the way the business is managed in order to raise enough money to pay off its debts. They may alternatively try to sell the business as a **GOING CONCERN** – this means that someone will buy the whole business, pay off its debts and carry on its' work as the new owner. If either of these actions work the business will come out of administration and be allowed to run with its' own managers again.

↓

If the business **CANNOT** pay back its debts (because it cannot be changed to run in a profitable way or sold as a going concern) then the **ASSETS** of the business and any unlimited owners will be sold to get cash which will be used to repay (some or all) of the debts of the business. This break up and sale of the business in parts is known as **LIQUIDATION**.

This means that the work by the Finance Department is very important to a business, because if it is done properly then it will make sure that the business **DOES NOT FAIL** because it will have enough financial information and money to operate effectively and pay its' bills.

RAISING FINANCE FOR BUSINESS ACTIVITIES

All businesses need FINANCE (money) to pay for the following items or it will simply be unable to start up, expand or continue its' activities.

- *PURCHASE OR USE OF PREMISES*
- *PURCHASE OR USE OF CAPITAL*
- *USE OF LABOUR*
- *USE OF ENTERPRISE*
- *BUSINESS GROWTH AND EXPANSION*
- *GENERAL RUNNING COSTS (eg electricity, raw materials, insurance, etc)*

The details of the 2 main sources of finance that are available to small to medium sized businesses in order to make these payments can be seen over the next few pages.

1 INTERNAL FINANCE

Internal finance is money that comes from **INSIDE** of the business itself. The main types of internal finance for small and medium businesses are as follows.

Finance	Description	Available for how long?	Available to whom?
CAPITAL 	Capital is the money invested in a business by an owner. This is **EQUITY** finance. This means that providing this type of finance results in some ownership and control of the business in return.	Until the owner closes the business or takes the money back.	• *SOLE TRADER* • *PARTNERSHIP* • *SOCIAL ENTERPRISE*
ORDINARY Shares 	These company shares provide their shareholders **VARIABLE DIVIDEND** (share of profit) based on available profits. This is **EQUITY** finance and allows a say in running the company. More of them can be sold to existing shareholders to raise finance.	Until the owner closes the business down.	• *PRIVATE COMPANY* • *PUBLI C COMPANY*
PREFERENCE Shares 	These company shares provide their shareholders with a **FIXED DIVIDEND** of any profit, before **ORDINARY** dividends are paid. This is **EQUITY** finance, but **DOES NOT** always allows a say in running the company. More of them can be sold to existing shareholders to raise finance.	Until the owner closes the business down.	• *PRIVATE COMPANY* • *PUBLI C COMPANY*
PROFITS 	Profits that have been made by businesses (and have not yet been spent or given to owners) can be used to pay for things.	Until the owner closes the business or uses it up.	• *SOLE TRADER* • *PARTNERSHIP* • *PRIVATE COMPANY* • *SOCIAL ENTERPRISE*
GOVERNMENT BUDGET 	The Government's budget provides an amount of money (raised from taxes, etc) that is given to managers of Public Sector businesses to fund their activities.	VARIABLE (depends on expected life of service)	• *PUBLIC SERVICES*

The main **ADVANTAGES** of using **INTERNAL** finance include the following.

- *Internal finance does NOT usually need to be repaid. This means that a business will be able to maximise revenue or profit as it does not have repayment and interest costs.*

- *Internal finance does NOT usually need to be repaid. This means that a business does not have any obligations to repayments which may make it fail if they are not made.*

- *Internal finance does NOT usually need to be repaid. This means that a business knows that it can rely on this money and so can plan for the future more effectively.*

- *Internal finance does not normally need to get approval about its use from people outside of the business (eg bank). This can make the business easier to run as this finance can usually be used in whatever manner the business likes.*

The main **DRAWBACKS** of **INTERNAL** finance include the following.

- *Use of some sources of internal finance can decrease the returns to each owner of a business. For example, if a business uses up profits as finance then it will not be available for the owners to draw from the business. This will also happen if more shares are issued because the same amount of profit will now be split between more owners. For example, if the was £100 profit and 100 owners then they would each be entitled to £1. However, if 100 more shares were issued then each owner would only now get 50p (£100/200).*

- *Use of equity sources of internal finance can decrease the control of each owner of a business. For example, if a 2 person equal partnership becomes a 3 person equal partnership then control will change from 50% for each partner to 33% for each partner.*

- *Internal finance is usually only available in limited amounts. This can mean that it cannot be used for everything that a business wants to do and so external sources may need to be accessed.*

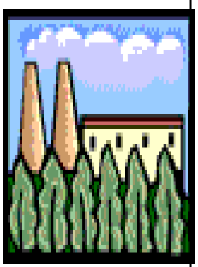
2 EXTERNAL FINANCE

External finance is money that comes from someone **OUTSIDE** of the business. Examples of these external providers of finance include:

- *COMMERCIAL BANKS (these are banks that deal with individuals and businesses eg Royal Bank)*
- *MERCHANT BANKS (these are banks that only deal with businesses)*
- *PENSION AND INSURANCE COMPANIES (they invest money to create profits for themselves)*
- *GOVERNMENT ORGANISATIONS*

External finance is made available from these providers in various forms and amounts. This finance is also differentiated by the period of time that it is made available – **SHORT**, **MEDIUM** and **LONG TERM**.

Common types of **LONG TERM EXTERNAL FINANCE** for small and medium businesses are as follows.

Finance	Description	Available for how long?	Available to whom?
MORTGAGE 	This is a specific type of loan to buy **PROPERTY**, eg factory. Mortgages must be repaid with **INTEREST**. Mortgages are **SECURED** loans – this means that the debt is linked to the property bought and it can be taken and sold to get any unpaid money back. However, despite this, mortgages are **NOT** equity finance.	LONG TERM (10+ years)	• *ALL BUSINESSES*
SALE AND LEASEBACK 	If a business owns an asset by paying for them in full (eg premises), then it could sell the asset and then rent it back. This allows the business to still use the asset but raise finance by releasing the cash tied up in it.	LONG TERM (10+ years)	• *ALL BUSINESSES*
VENTURE CAPITALIST 	Here part of the business is sold to a **VENTURE CAPITALIST**. This is an outside party who invests in businesses to make money though **DIVIDENDS** and then selling their share later for profit. This is **EQUITY** capital.	LONG TERM (10+ years)	• *SOLE TRADER* • *PARTNERSHIP* • *PRIVATE COMPANY* • *PUBLIC COMPANY*
DEBENTURE 	PLCs can get private individuals to loan them money by getting them to buy a DEBENTURE. This non-equity "IOU" agreement will provide business with cash and the investor with a fixed rate of interest and full repayment in the future.	LONG TERM (10+ years)	• *PUBLIC COMPANY*

Finance	Description	Available for how long?	Available to whom?
STOCK MARKET  	The Stock Market is where the **SHARES** in PLCs are bought and sold by investors (who can be individuals or **INSTITUTIONAL INVESTORS** [other businesses]). Stock Markets can be physical places (eg London, Tokyo and New York Stock Exchanges), but many "trades" are now computerised and so are no longer face-to-face. The stock market price for a PLC's shares changes every day based on how well investors believe it is doing now or will do in the future. This is because if investors think a PLC is going to perform well (and so pay good dividends) they will drive up share prices as they "outbid" each other to get them. While on the other hand, if investors think the performance of a PLC is poor then demand for its' shares will fall and so share prices will drop as they have to be "cheap" to be sold at all. The importance of information about business performance in determining share demand and price means that PLCs must provide the stock market with updates about their profits and activities so that investors have "fair" access to the information they need to appropriately "value" shares. Failure to do this or **INSIDER DEALING** (secret use of information to "beat" the market by doing things before others) is illegal and can result in court action and suspension of the company from being traded on the stock market. The general changes in share prices in a stock market can be tracked through a **STOCK INDEX** – this is an average of how the price of the most valuable shares are performing, eg the FTSE100 (UK), S&P500 (USA) and NIKKEI225 (Japan). When indices are rising this signals what is known as a **BULL MARKET** (lots of people are buying) and when they fall this is known as a **BEAR MARKET** (many people are selling). The Stock Market can be used to raise finance for a PLC in the following ways: **1** **SELLING NEW SHARES** – A PLC can create new shares and sell them in the stock market to new investors to bring in cash. This creates new **EQUITY CAPITAL**. **2** **INVESTING IN SHARES** – A PLC can buy shares in other PLCs in order to make money from dividends and hoping that these share prices increase over time so it can be sold for a "profit". Although businesses should be wary of a stock market **CRASH** (a massive unexpected drop in share prices) which would result in a large "loss" instead.	LONG TERM (10+ years)	• *PUBLIC COMPANY*

Common types of **MEDIUM TERM EXTERNAL FINANCE** for small and medium businesses are as follows.

Finance	Description	Available for how long?	Available to whom?
LOAN 	This is money that is given which has to be repaid with **INTEREST**. Loans are **NOT** equity finance. Loans can be **SECURED** which means they asset they are used to buy can be taken if repayments are not made.	MEDIUM TERM (1-10 years)	• *ALL BUSINESSES*
HIRE PURCHASE 	Here the business buys an asset (eg van) by paying the purchase price and interest over a period of time. The business looks after and uses the asset while it is paying for it and will own it after the final payment. This means that the business does not need all the money for the asset at once and can use it to create revenue to make its' repayments.	MEDIUM TERM (1-10 years)	• *ALL BUSINESSES*
LEASE 	Here the business uses an asset (eg van) by making a rental payment. Here even though the business is paying for the use of the asset, it will **NEVER** own it. However, rented assets will be repaired and upgraded by their owner rather than the business itself which can save money and allow easy access to updated assets.	MEDIUM TERM (1-10 years)	• *ALL BUSINESSES*
GRANTS 	Here the business receives a sum of money that **DOES NOT** have to be repaid. This is often from a Government or charitable body (eg Prince's Trust) which is looking to support businesses is particular areas or markets.	MEDIUM TERM (1-10 years)	• *ALL BUSINESSES*

Common types of **SHORT TERM EXTERNAL FINANCE** available to small and medium businesses are as follows. However, it should be noted that any businesses which have to often rely on these short term methods of finance are likely to be suffering cash flow problems and so may be close to failing.

Finance	Description	Available for how long?	Available to whom?
OVERDRAFT 	This is a small loan that allows a business to spend more money than it has in its bank account. Overdrafts are automatically repaid as soon as money is paid into the bank and so a business will not be able to choose how much to repay at any time.	SHORT TERM (<1 year)	• *ALL BUSINESSES*
DEBT FACTORING 	Here the business sells debts people owe it to a collection company. This gives the business most of the money that it is owed all at once. The collection company is happy to do this as they will make a profit by charging interest on the debts due.	SHORT TERM (<1 year)	• *ALL BUSINESSES*
TRADE CREDIT 	Here the business tries to get people who owe money to pay quickly while the business itself takes as much **CREDIT** as it can get. This can provide some cash as money is coming in from people paying but it not having to be spent on repayments straight away.	SHORT TERM (<1 year)	• *ALL BUSINESSES*

The main **ADVANTAGES** of using **EXTERNAL** finance are as follows.

- *There are many different sources and types of external finance which can be used to provide quick access to large amounts of money. This can mean that a business will be able to develop more quickly as it does not have to wait until they have enough of their own money to pay for what they want to do.*

- *Popular PLCs can use debentures and the issue of new share in the stock market quickly access large amounts of money. This can mean that the PLC will be able to grow and develop quickly as it does not have to wait until it has enough of it's own money to pay for what it wants to do.*

- *Use of external finance can increase the revenue and profits of a business. This can happen because external finance allows a business to buy and use revenue generating assets immediately rather than having to wait until enough internal finance becomes available in the future.*

- *Use of external finance usually does not affect the running of the business. This is because most external finance is not equity finance and so does not usually give providers a say in the running of the business.*

However, using **EXTERNAL** finance can have the following **DRAWBACKS**.

- *External finance normally requires payment to the lender (usually the amount used plus extra interest charges). This means that a business will have to lose some revenue or profit to make these repayments.*

- *External finance normally requires payment to the lender (usually the amount used plus extra interest charges). This means that the owners of a business will experience lower returns from it because the business will have to lose some revenue or profit to make repayments.*

- *External finance normally requires payment to the lender (usually the amount used plus extra interest charges). This means that a business now has an obligation to make these repayments or it can fail if they are not made.*

- *Securing external finance will involve the lender investigating the business and deciding if it is worth lending to because it is likely to make its' repayments. This can delay and complicate getting access to finance which can result in a lack of progress for the business.*

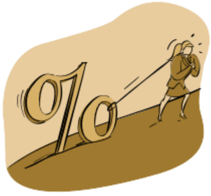
- *Securing external finance will involve the lender investigating the business and deciding if it is worth lending to because it is likely to make its' repayments. This can mean that a business may not get the finance that it need and so it may fail because of the decisions of other people.*

- *Selling new shares in the stock market can decrease the returns to existing shareholders in a PLC. For example, if the was £100 profit and 100 shareholders then they would each be entitled to £1. However, if 100 more shares were issued in the stock market then each shareholder would only now get 50p (£100/200).*

- *Selling new shares in the stock market can decrease the amount of control existing shareholders have in a PLC. For example, if a PLC had 100 shares then each share owned would give the owner a say worth 100th of the total control of the business. However, if 100 more shares were issued in the stock market then each share owned would give the owner a say worth 200th of the total control of the business.*

- *Selling shares in the stock market can mean that existing owners can lose control of their PLC through a "take over". This means that new owners buy enough shares (from some existing owners) to take control of the PLC and so become able to decide what it should do.*

The factors which are likely to influence decisions about the **AMOUNT** and **TYPE** of finance that is used in a business can be seen below.

Factor	Description
COST 	Businesses will want to minimise the cost of any source of finance that they use. This generally means that internal finance is preferred. However, when this is not available, most businesses will want to use external finance with low interest rates.
TIME PERIOD 	Different methods of finance are available for different periods of time. Therefore, businesses should choose a method that suits the time period they need it for in order to help minimise costs. For example a business would not choose a loan instead of an overdraft to cover a small payment that would be repaid soon because this would commit them to interest payments for a longer period of time than necessary.
EQUITY 	Equity finance provides a share of ownership and so businesses will have to carefully consider how this will impact on control and returns for owners before deciding to use it.
BUSINESS TYPE 	Some businesses simply do not have access to particular types of finance due the type of business that they are. For example, sole traders cannot issue shares and only PLCs can issue debentures.

DEALING WITH PAYMENTS RECEIVED

*The **DEALING WITH PAYMENTS RECEIVED** part of Finance's work is all about making sure that any money received is recorded and banked correctly.*

The business will receive money from consumers as payment for the goods and services that they have bought. This money is often known as **RECEIPTS**. Common methods of payments used to pay for things that have been bought include the following.

- *CASH*
- *CHEQUE (written instruction to a bank to make a payment)*
- *DEBIT CARD PAYMENT (an electronic transfer between bank accounts)*
- *CREDIT CARD PAYMENT (a payment by a credit card company on someone's behalf that they will have to then repay later [with interest if the full amount is not received at once]).*

When these payments are received, the Finance staff will complete the following activities to process the payment.

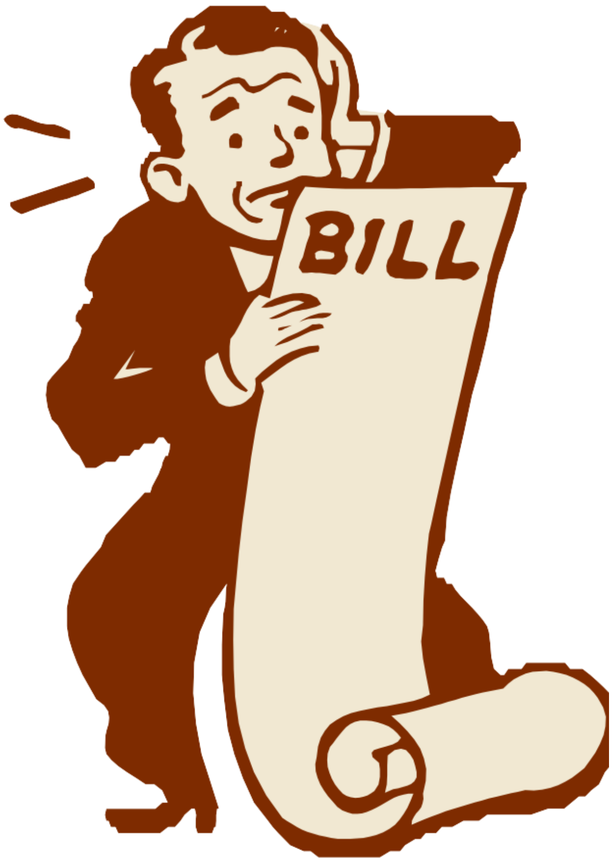
- *CHECK THAT THE AMOUNT PAID IS CORRECT*
- *RECORD THE PAYMENT*
- *DEDUCT THE PAYMENT FROM ANY BALANCE OWED*
- *ENSURE PAYMENTS ARE CORRECTLY ENTERED INTO THE SAFETY OF THE BUSINESS BANK ACCOUNT*

PAYING FOR BUSINESS ACTIVITIES

*The **PAYING FOR BUSINESS ACTIVITIES** part of Finance's work is all about preventing business failure by using finance raised and payments received to pay all of the bills of the business on time.*

The main payments that have to be made for activities that keep the business running are as follows.

- *STAFF WAGES (this is known as PAYROLL)*
- *PROFIT PAYMENTS TO OWNERS*
- *RENT OF PREMISES*
- *INSURANCE FOR PREMISES*
- *LIGHT, HEAT AND POWER FOR PREMISES*
- *PURCHASE OF RAW MATERIALS*
- *STORAGE OF STOCKS*
- *TRANSPORT OF FINISHED GOODS*
- *TAXES ON PROFITS*
- *PURCHASE OF NEW PREMISES*
- *PURCHASE OF NEW EQUIPMENT*



MANAGING CASHFLOW

*This part of Finance's work is concerned with managing the use of cash in the business so that it has a positive **CASHFLOW** and does not fail because it has run out of money.*

The **CASHFLOW** of a business refers to how the amount of cash available to the business is affected by the money coming into it (from finance and sales) and the money going out of it (as payments).

This part of Finance's work is critical in all businesses. This is because businesses need cashflow to be **POSITIVE** (which means more cash is coming on than is going out) in order to increase the overall amount of money that they have and so minimise the chance of going bust.

This work requires careful management as there are many reasons why a business could easily get into a situation which causes cashflow to become **NEGATIVE** and so increase the likelihood of business failure as it can no longer pay its' bills.

Common examples of these **CASHFLOW PROBLEMS** that can be encountered in businesses can be seen below.

- *STOCKPILING (holding lots of stock will tie up cash and so decrease the amount that can be spent)*
- *OVERTRADING (large outflows to pay for lots of production at once can mean there is little cash left)*
- *OVERINVESTMENT (large outflows to buy expensive assets can mean little cash is left over)*
- *TOO MANY CREDIT SALES (this decreases cash inflows as payments will be made at a later date)*
- *TOO MANY CREDIT PURCHASES (future cash outflows as repayments will decrease cash available then)*
- *INFLATION (inflation will make outflows to pay for business costs rise and so can decrease cash available)*
- *EMERGENCIES (this can mean quick and unexpected outflows [eg machine repair] and less cash)*
- *FALL IN DEMAND (this can cause cash inflows to drop and so a decrease in cash available)*
- *SEASONAL FACTORS (cash flow can vary and drop over time due to social or environmental factors)*

To help businesses carry out the efficient management of cashflow that is required to try to avoid the above cashflow problems, they will often regularly gather and act on information about cashflow. This can be done through preparing and using the information in a **CASH BUDGET**.

CASH BUDGET

> ***CASH BUDGETS*** *are documents which show whether a business is expected to have cash* ***SURPLUSES*** *(extra cash) or* ***DEFICITS*** *(lack of cash) in the* ***FUTURE****.*

The main parts of a Cash Budget are as follows.

- *OPENING BALANCE (the amount of cash available at start of the budget)*
- *RECEIPTS (cash that is flowing in from sales, etc)*
- *CASH AVAILABLE (total cash available during a period before payments are made)*
- *PAYMENTS (cash flowing out from bill payments, wages, etc)*
- *CLOSING BALANCE (the amount of surplus of deficit at end of each period)*

The layout and structure of a Cash Budget can be seen below.

Cash Budget for A King for Jan 2020 – Mar 2020

		£ Jan	£ Feb	£ Mar
	OPENING BALANCE	**10,000**	**5,000**	**0**
	RECEIPTS			
	Cash Sales	*5,000*	*2,500*	*2,500*
	Credit Sales	*5,000*	*2,500*	*2,500*
	Bank Loan	*10,000*	-	-
+	**TOTAL RECEIPTS**	**20,000**	**5,000**	**5,000**
=	**CASH AVAILABLE**	**30,000**	**10,000**	**5,000**
	PAYMENTS			
	Rent	*500*	*500*	*500*
	Wages	*5,000*	*5,000*	*5,000*
	Cash Purchases	*2,000*	*2,000*	*2,000*
	Credit Purchases	*2,500*	*2,500*	*2,500*
	Purchase of Equipment	*15,000*	-	-
-	**TOTAL PAYMENTS**	**25,000**	**10,000**	**10,000**
=	**CLOSING BALANCE[1]**	**5,000**	**0**	**- 5,000**

[1] The **CLOSING BALANCE** for one period in the Cash Budget will be the **OPENING BALANCE** for the next period. For example, as you end January with £5,000 cash, then you start February with £5,000 cash.

Cash budgets can help with the cashflow management of a business because they can provide advance information about what should happen to its' money in the future. This is beneficial for a business as this can mean that it is less likely to fail for the following reasons.

1 DEFICITS CAN BE PREVENTED OR DEALT WITH

Any future deficits (shortages of funds) highlighted by the Cash Budget can be avoided or dealt with before they occur by undertaking some or all of the activities below.

- *ARRANGE AN OVERDRAFT (this will provide more cash now to prevent future deficits)*
- *ARRANGE A LOANS (this will provide more cash now to prevent future deficits)*
- *SELL OFF EXCESS STOCK (this will increase cash inflows now to prevent future deficits)*
- *SELL OFF UNNECESSARY ASSETS (this will increase cash inflows now to prevent future deficits)*
- *CUT BACK ON NON ESSENTIAL INVESTMENTS (this will decrease outflows and so prevent the deficit)*
- *LOWER STAFF COSTS (deficits can be prevented by cutting cash outflows on overtime, etc)*
- *LOWER LAND COSTS (deficits can be prevented by cutting cash outflows by moving premises, etc)*
- *INCREASE SALES (deficits can be prevented by increasing cash inflows from better marketing, etc)*
- *SPEED UP DEBT REPAYMENTS (more cash becomes available now to minimise future deficits)*
- *DELAY CREDIT REPAYMENTS (this prevents cash outflows now to minimise chance of a future deficit)*

Using these activities to deal with any deficits before they actually occur is particularly important. This is because if the deficit is not prevented and actually occurs then this means that the business will NOT have enough money to pay its' bill and so is likely to fail.

2 SURPLUSES CAN BE EFFICIENTLY USED

Cash budgets can allow plans to be made about the best way and time to use any future surpluses to benefit the business. Examples of the beneficial activities that surpluses can be used for include the following.

- *SAVING CASH FOR FUTURE USE (this will be known as a RESERVE)*
- *INVESTMENTS*
- *LARGE PURCHASES (eg new machinery, etc)*

PREPARING THE FINAL ACCOUNTS

The **FINAL ACCOUNTS** of a business provide financial information about its' financial performance and overall worth.

The two documents that together are known as the Final Accounts are the "Trading and Profit and Loss Accounts" and the "Balance Sheet". Details of both of these documents can be seen below.

1 TRADING AND PROFIT AND LOSS ACCOUNTS

This document aims to show how much of a **PROFIT** (extra money earned) or **LOSS** (decrease in money available) a business has made during a **PREVIOUS** period of time (usually 1 year). The main parts of the Trading and Profit and Loss Accounts are as follows.

- *TRADING ACCOUNT*

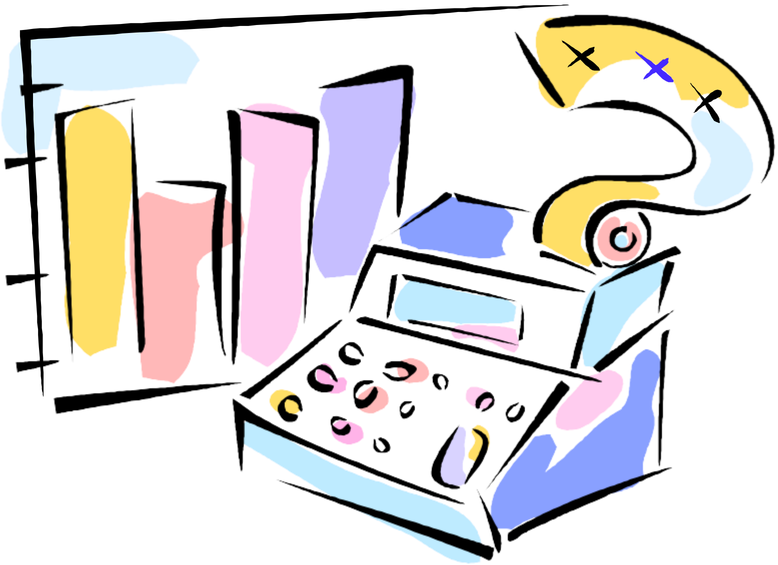
  This shows **GROSS PROFIT** (money made from just buying and selling products). It is calculated by subtracting **COST OF SALES** (purchasing and manufacturing costs of products sold) from **SALES**.

- *PROFIT AND LOSS ACCOUNT*

  This shows **NET PROFIT** (amount of money left for owners after paying all other **EXPENSES** [running costs]). It is calculated by subtracting **EXPENSES** from **GROSS PROFIT**.

- *APPROPRIATION ACCOUNT*

  This is **ONLY** used in the accounts of **PARTNERSHIPS** and **COMPANIES** because it shows how Net Profit is shared between all of the owners.



The layout and structure of a typical set of Trading and Profit and Loss Accounts can be seen below.

	Trading and Profit and Loss Accounts for A King for the year ended 31 December 2020			
		£	**£**	
	SALES		**100,000**	**Trading A/c**
	Opening Stock	*5,000*		
(+)	*Purchases*	*50,000*		
		55,000		
(-)	*Closing Stock*	*15,000*		
-	**COST OF SALES**		**40,000**	
=	**GROSS PROFIT**		**60,000**	
	Wages	*20,000*		**Profit and Loss A/c**
	Rent	*5,000*		
	Rates	*1,000*		
	Advertising	*4,000*		
-	**EXPENSES**		**30,000**	
=	**NET PROFIT**		**30,000**	

2 THE BALANCE SHEET

This document aims to show at a specific point in time the value of the **ASSETS** of business (things that are of worth) and how they have been **FINANCED** (paid for). The main parts of the Balance Sheet are as follows.

- *NET WORTH SECTION*

  This shows **NET WORTH** (value of everything the business owns). It is calculated by subtracting **LIABILITIES** (money owed to others) from **ASSETS** (things of value). This calculation involves the following entries.

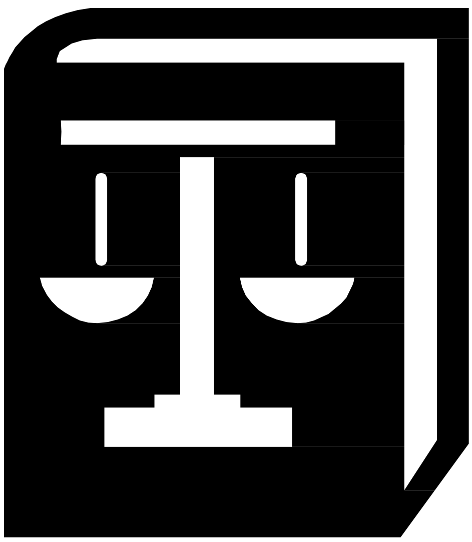
  - *FIXED ASSETS (assets which are used for a long time [>1 yr])*
  - *DEPRECIATION (decrease in Fixed Asset value to account for use)*
  - *CURRENT ASSETS (assets which are used up quickly [<1 yr])*
  - *DEBTORS (people who owe money TO THE BUSINESS)*
  - *CURRENT LIABILITIES (debts which have to be paid soon [<1 yr])*
  - *CREDITORS (people the business OWES MONEY TO)*
  - *WORKING CAPITAL (approximation of the money available for use at the moment)*

- *FINANCED BY SECTION*

  This shows how the assets that make up Net Worth have been paid for, and so will include the items shown below.

  - *CAPITAL (including SHARES for companies)*
  - *LONG TERM LIABILITIES (eg loans, mortgages)*
  - *RETAINED PROFITS (ie profits not yet spent)*

  As this section shows how assets are financed then it must have an EQUAL VALUE to the Net Worth section, ie it must BALANCE with it. This is because assets CANNOT be owned by the business WITHOUT PAYMENT.



The layout and structure of a Balance Sheet can be seen below.

Balance Sheet for A King for the year ended 31 December 2020

		£	£	£	
	FIXED ASSETS	Cost	(-) Depn	(=) Book Value	**Net Worth Section**
	Premises	*80,000*	*0*	*80,000*	
(+)	*Van*	*25,000*	*5,000*	*20,000*	
				100,000	
	CURRENT ASSETS				
	Closing Stock		*15,000*		
(+)	*Debtors*		*10,000*		
(+)	*Bank*		*4,000*		
(+)	*Cash*		*1,000*		
			30,000		
	CURRENT LIABILITIES				
(-)	*Creditors*		*10,000*		
+	**WORKING CAPITAL**			**20,000**	
=	**NET WORTH**			**120,000**	
	FINANCED BY				**Financed By Section**
	Capital			*10,000*	
(+)	*Mortgage*			*80,000*	
(+)	*Profits*			*30,000*	
				120,000	

RATIO ANALYSIS

RATIO ANALYSIS involves carrying out calculations based on information in the **FINAL ACCOUNTS** to provide extra information about the performance of a business.

Although the Final Accounts provide values for profits and worth, ratio analysis can be used to provide other important (but less obvious) information about the following.

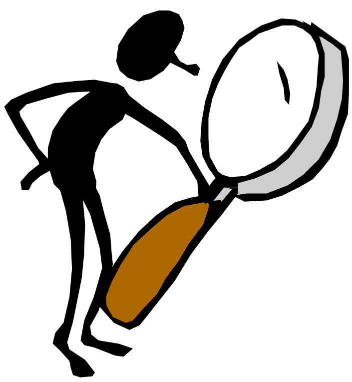
- *CHANGES IN PERFORMANCE RELATIVE TO BEFORE (INTRA COMPARISON)*
- *CHANGES IN PERFORMANCE RELATIVE TO OTHER BUSINESSES (INTER COMPARISON)*
- *REASONS WHY PERFORMANCE HAS CHANGED*
- *ACTIONS WHICH MAY NEED TO BE TAKEN TO IMPROVE PERFORMANCE*

This information from ratio analysis is regularly used by the following **STAKEHOLDERS** to help them manage their dealings with a business.

- *MANAGERS (to record, analyse, evaluate and control financial activities)*
- *OWNERS (to evaluate the return and worthiness of the capital invested)*
- *EMPLOYEES (to bargain for better conditions if there is lots of profit)*
- *TRADE UNIONS (to bargain on behalf of workers for wage rises if there is lots of profit)*
- *POTENTIAL INVESTORS (to check whether the business is worth investing in)*
- *STOCKMARKET (to assess PLC value)*
- *CREDITORS (to check that the business is worth selling to on credit as it can repay)*
- *LENDERS (to check that the business is worth giving finance to as it can repay)*
- *GOVERNMENT (to assess tax/VAT due to be paid *PLC's must make available+)*
- *ECONOMISTS (for use in research)*
- *COMPETITORS (to compare performance and change their work to try and compete)*
- *GENERAL PUBLIC/MEDIA (to check actions are acceptable - eg price and profit levels, staff wages, etc)*

The calculations which are used to carry out ratio analysis can be broken down into the following categories and more information about them can be seen over the next few pages.

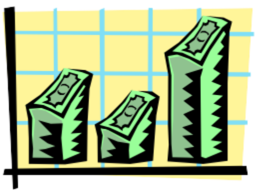
- *PROFITABILITY (profit levels)*
- *LIQUIDITY (ability to pay debts)*
- *EFFICIENCY (how well resources are being used)*



1 PROFITABILITY RATIOS

Profitability Ratios are calculated to analyse changes in the profits of the business. This is so that users of the accounts can see if the business is doing better or worse than before. If users discover negative issues in these ratios then they should take steps to find the reasons for them and act to address them so that future performance improves. Common Profitability Ratios can be seen below.

Ratio	Formula	Change means?	Reason for change?
GROSS PROFIT RATIO	$\frac{\text{Gross Profit}}{\text{Sales}} \times 100\%$ This ratio shows the profit (as a percentage of sales) from buying and selling (**TRADING**).	• INCREASE – POSITIVE as this means MORE PROFIT from trading. • DECREASE – NEGATIVE as this means LESS PROFIT from trading.	• INCREASE from MORE sales (from better marketing) or LOWER cost of sales (from cheaper suppliers). • DECREASE from LESS sales (from poor marketing) or HIGHER cost of sales (from rising prices).
NET PROFIT RATIO	$\frac{\text{Net Profit}}{\text{Sales}} \times 100\%$ This ratio shows the amount of profit (as a percentage of sales) after paying ALL costs.	• INCREASE – POSITIVE as this means MORE PROFIT to finally keep. • DECREASE – NEGATIVE as this means LESS PROFIT to finally keep.	• INCREASE from MORE Gross Profit (as above), or LOWER expenses (from cheaper suppliers). • DECREASE from LESS Gross Profit (from better marketing or cheaper suppliers), or HIGHER expenses (from price rises).
RETURN ON CAPITAL EMPLOYED	$\frac{\text{Net Profit}}{\text{Capital Employed}} \times 100\%$ This ratio shows the percentage return on the investment made, ie the “interest rate” the business provides.	• INCREASE – POSITIVE as this is a HIGHER return to owners. • DECREASE – NEGATIVE as this is a LOWER return to owners.	• INCREASE from MORE Sales (due to better marketing) or LOWER costs (from cheaper suppliers). • DECREASE from LESS Sales (from poorer marketing), HIGHER costs (from rising supplier prices) or INCREASED INVESTMENT.
MARK UP RATIO	$\frac{\text{Gross Profit}}{\text{Cost of Sales}} \times 100\%$ This ratio shows the percentage of cost added on as profit when setting prices.	• INCREASE – POSITIVE as this means MORE PROFIT. • DECREASE – NEGATIVE as this means LESS PROFIT.	• INCREASE from HIGHER prices charged or LOWER cost of sales (due to falling supplier prices). • DECREASE from LOWER prices to stimulate sales or HIGHER cost of sales (due to rising supplier prices).



2 LIQUIDITY RATIOS

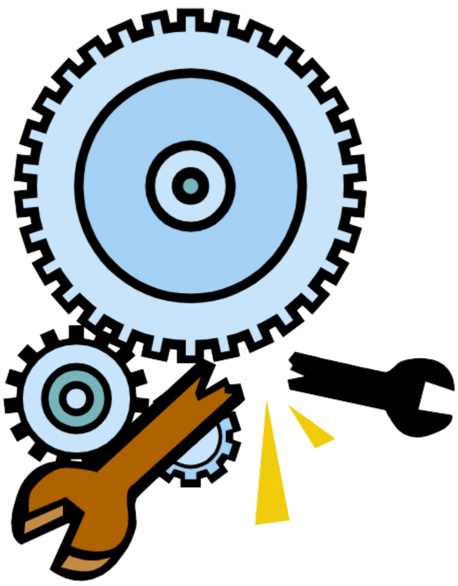
Liquidity Ratios are calculated to analyse changes in the ability of the business to pay its debts. This is so that users of the accounts can see if the business has have enough money to keep going. If users discover negative issues in these ratios then they should take steps to find the reasons for them and act to address them so that future performance improves. Common Liquidity Ratios can be seen below.

Ratio	Formula	Change means?	Reason for change?
CURRENT RATIO	*Current Assets : 1* *Current Liabilities* This ratio shows the ability of the business to pay debts. A minimum of 1:1 is required (otherwise there will not be enough assets to pay the bills) but 2:1 is preferred.	• INCREASE – POSITIVE as this means INCREASED ABILITY to pay debts and so less chance of failure. • DECREASE – NEGATIVE as this means DECREASED ABILITY to pay debts and more chance of failure.	• INCREASE from MORE Current Assets or LESS Current Liabilities. • DECREASE from LESS Current Assets or MORE Current Liabilities.
ACID TEST RATIO	*Current Assets – Stock :* *1 Current Liabilities* This ratio shows the ability of the business to quickly pay debts without having to wait to sell off stock. A minimum of 1:1 is required otherwise there are not enough assets to quickly pay the bills.	• INCREASE – POSITIVE as this means INCREASED ABILITY to pay debts quickly and so less chance of failure. • DECREASE – NEGATIVE as this means DECREASED ABILITY to pay debts quickly and more chance of failure.	• INCREASE from MORE Current Assets (EXCEPT Stocks) or LESS Current Liabilities. • DECREASE from LESS Current Assets (EXCEPT Stocks) or MORE Current Liabilities.

3 EFFICIENCY RATIOS

Efficiency Ratios are calculated to analyse changes in how well the business is using its assets. This is so that users of the accounts can see if the business is operating as well as it could be. If users discover negative issues in these ratios then they should take steps to find the reasons for them and act to address them so that future performance improves. Common Efficiency Ratios can be seen below.

Ratio	Formula	Change means?	Reason for change?
RATE OF STOCK TURNOVER	*<u>Cost of Sales</u> TIMES* *Closing Stock* This ratio shows the number of times that stock is sold out during the year.	• INCREASE – POSITIVE as this means that stocks are being sold quickly and so they are not being wasted. • DECREASE – NEGATIVE as this means that stocks are being sold slowly and so they could be obsolete.	• INCREASE from LOWER cost of sales or more efficient stock control which is tying up less cash in stocks. • DECREASE from HIGHER cost of sales or less efficient stock control which is tying up less cash in stocks.
ASSET USE	*<u>Sales</u> x 100%* *Fixed Assets* This ratio shows the amount of sales that the investment in fixed assets is creating for a business.	• INCREASE – POSITIVE as this means each asset is producing MORE SALES. • DECREASE – NEGATIVE as this means each asset is producing LESS SALES.	• INCREASE from BETTER USE of assets from more staff training. • DECREASE from POORER USE of assets from inefficient or unskilled staff.



Although ratio analysis does provide lots of useful information that is beneficial for financial management, there are still the following issues and limitations that users should account for when using them.

1 VARIATION IN ACCOUNTING STANDARDS

Accounting standards are professional rules that are used for preparing final accounts. As different businesses and countries can use different standards, this can mean that the same information could be prepared in different ways. Therefore, if a user is unaware of differences from varying rules then they can misinterpret the ratio information that comes from these final accounts and make poor decisions.

2 SUBJECTIVE VALUES

Some figures used in the final accounts are SUBJECTIVE. This means that their value is based on a professional opinion and so may not be entirely accurate. This will affect the accuracy and usefulness of any ratios that are based on these figures.

3 HISTORICAL VALUES

The information in final accounts are HISTORIC. This means that it is based on what has happened and so ratios created from these values cannot always be relied upon for accurately making decisions about the future.

4 MONETARY VALUES

Information in the final accounts and their ratios is only based on money based data. This means that users must be careful that when they are making decisions based on this financial information that they are not ignoring some of the following important factors which will not have been accounted for.

- *POSITIVE HIGH STAFF MORALE or NEGATIVE LOW STAFF MORALE*
- *POSITIVE LOW STAFF TURNOVER or NEGATIVE HIGH STAFF TURNOVER*
- *CUSTOMER LOYALTY TO PRODUCTS*
- *LEVEL OF ABILITIES/SKILLS/EXPERIENCE OF STAFF*
- *VALUABLE RESEARCH AND DEVELOPMENT*
- *POSITIVE NEW PRODUCT DEVELOPMENT*
- *MONOPOLY OF A MARKET AND PRICE CONTROL*
- *POSITIVE SOCIAL CONCERNS/DUTIES WHICH CREATE STRONG SUPPORT FOR A BUSINESS*
- *NEGATIVE SOCIAL CONCERNS/DUTIES WHICH CREATE PROBLEMS AND COSTS FOR A BUSINESS*

5 COMPARISON ISSUES

Different types of businesses would expect to have different results in their ratios. For example supermarkets are likely to have an almost daily rate of stock turnover ratio (to make sure products don't go out of date) while a car dealership may only normally turnover stock every few months. This means that users should take care when comparing ratio performances between businesses as "like with like" comparisons are the most valid and meaningful.

BREAKEVEN ANALYSIS

***BREAKEVEN ANALYSIS** is a process that uses the receipts and payments of a business to show calculate its' **BREAKEVEN POINT**.*

The **BREAKEVEN POINT** for a business is the amount of sales it needs to make in order to cover all of its costs. At this point, the business is neither making a **LOSS** (this is where there is more money going out than is coming in) or a **PROFIT** (this is where more money is coming in than is going out).

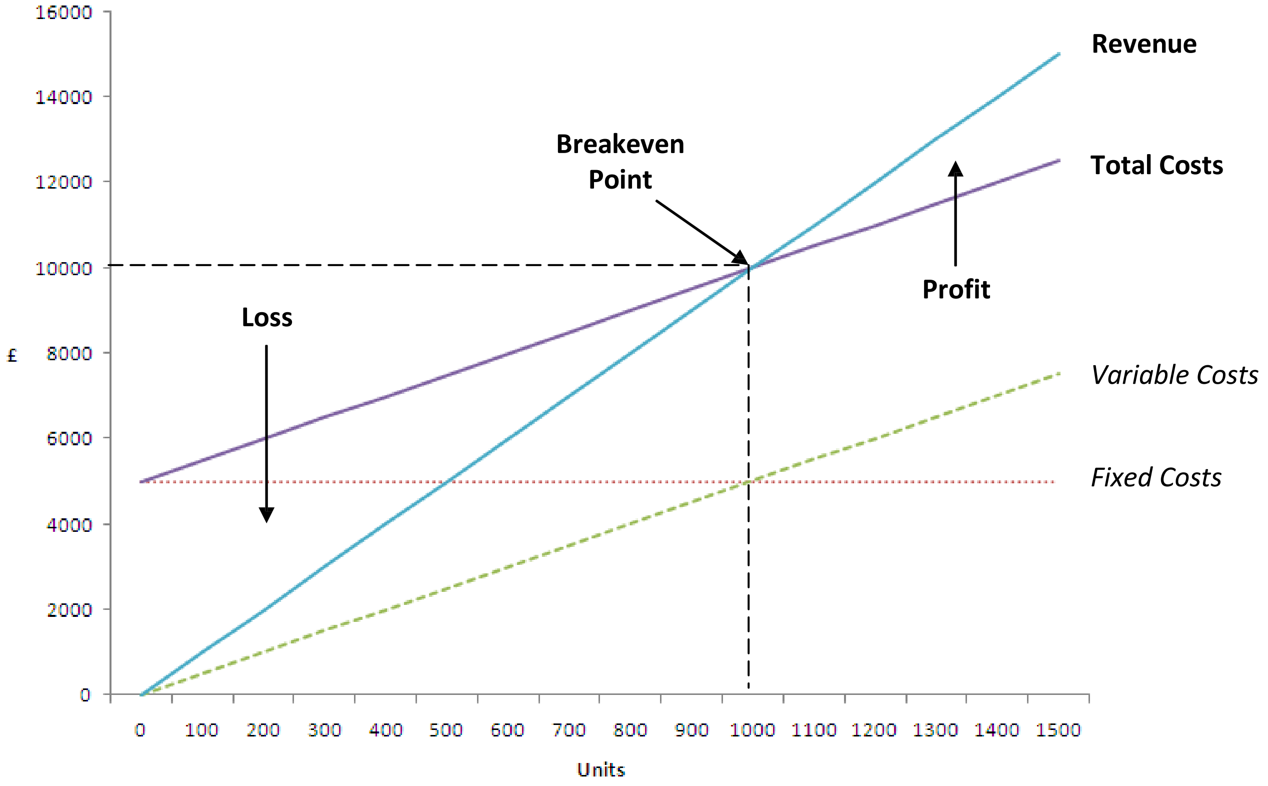
To calculate its' breakeven point, a business will have to gather the following data.

Data	Description
FIXED COSTS 	A fixed cost is one that **DOES NOT** usually change with the amount of products that a business makes. Examples of fixed costs include the following. • *RENT* • *RATES (this is a land tax to the Government based on the size of premises)*
VARIABLE COSTS 	A variable cost is one that **DOES** change with the amount of products that a business makes. Examples of variable costs include the following. • *WAGES (as more things are made more staff will be needed)* • *RAW MATERIALS (as more things are made more parts will be needed)*
TOTAL COSTS 	Total costs are the overall amount of fixed and variable costs that a business is paying for production.
REVENUE 	Revenue is the amount of money that a business is making from selling goods and services.

Businesses will be able to use this data to produce a **BREAKEVEN CHART** in order to calculate and visually show:

- *BREAKEVEN POINT (found where total costs **EQUAL** total revenue);*
- *LOSS (found where total costs are **MORE THAN** total revenue);*
- *PROFIT (found where total costs are **LESS THAN** total revenue).*

An example of a breakeven chart can be seen below.



Breakeven analysis is useful to a business for the following reasons.

- *BREAKEVEN ANALYSIS ALLOWS A BUSINESS TO SEE HOW MANY SALES IT WILL HAVE TO MAKE TO ELIMINATE LOSSES. THIS CAN HELP A BUSINESS SEE IF IT HAS ENOUGH FINANCE TO BE ABLE TO AFFORD TO WAIT THIS LONG OR WHETHER IT WILL HAVE TO SEEK MORE MONEY TO PREVENT FAILING BEFORE BREAKEVEN.*

- *BREAKEVEN ANALYSIS CAN SHOW EXTERNAL FINANCE PROVIDERS THAT A BUSINESS WILL BE PROFITABLE. THIS CAN HELP THE BUSINESS BECAUSE IT CAN PERSUADE THESE FINANCE PROVIDERS TO GIVE THE BUSINESS MONEY AS THEY CAN SEE THAT IT WILL BE ABLE TO MAKE MONEY AND PAY THEM BACK.*

- *THE BREAKEVEN POINT WILL HELP MARKETING AND OPERATIONS DECIDE HOW MUCH TO MAKE AND ADVERTISE. THIS WILL HELP THE BUSINESS MINIMISE WASTED PRODUCTION COSTS AND ENSURE THAT PROMOTION IS STRONG ENOUGH TO GET BEYOND THE BREAKEVEN POINT OF SALES.*

- *BY COMPARISON TO PROFIT AND LOSS ACCOUNTS, BREAKEVEN CHARTS MAY MAKE IT EASIER FOR PEOPLE TO UNDERSTAND THE PERFORMANCE OF THE BUSINESS AND SO HELP THEM BETTER MANAGE IT.*

SPREADSHEETS

SPREADSHEETS *are computer programs that store and manage* ***NUMERICAL*** *information through the use of computerised calculations (known as* ***FORMULAS****) which should ensure that results are always* ***ACCURATE*** *and* ***AUTOMATICALLY UPDATE****.*

In many businesses nowadays, financial information (such Cash Budgets, Trading and Profit and Loss Accounts, or Breakeven Analysis) will be produced using a **SPREADSHEET** computer program.

Spreadsheets are being used more often for financial management tasks because of the following benefits they can bring compared to doing this work manually or though use of a calculator.

- *FORMULA CAN BE USED TO QUICKLY AND ACCURATELY CALCULATE INFORMATION*
- *FORMULA CAN BE USED TO UPDATE INFORMATION AUTOMATICALLY AND SO MINIMISE ERRORS*
- *EASY UPDATES ALLOW "WHAT IF" ANALYSIS TO INVESTIGATE RESULTS FROM DECISIONS*
- *CHARTS CAN BE CREATED FROM EXISTING INFO TO IMPROVE UNDERSTANDING*
- *ELECTRONIC SECURITY CAN BE EASILY PUT IN PLACE TO KEEP IMPORTANT FINANCIAL DATA SECURE*
- *AN EXTRA COPY (BACKUP) OF INFORMATION CAN EASILY BE KEPT TO DEAL WITH DATA ERRORS OR LOSS*

However, businesses which decide to use spreadsheets will have to accept the following costs:

- *COST OF PURCHASING THE NECESSARY IT HARDWARE AND SPREADSHEET SOFTWARE*
- *STAFF TRAINING TO ENSURE THAT THEY ARE SUITABLY SKILLED TO USE SPREADSHEETS*
- *POSSIBLE LOSS OF INFORMATION FROM EQUIPMENT PROBLEMS OR STAFF ERRORS*

WHICH FACTORS CAN AFFECT THE SUCCESS OF FINANCE ACTIVITIES?

The success of any operations activities undertaken by a business will be affected by the following factors. Therefore, a business should monitor each of these factors carefully and adjust their operations activities to deal with them in order to make sure that its' operations are as successful as possible.

1 INTERNAL FACTORS

Issue	Activity
FINANCE 	When a business has **LOTS** of finance (money) then it can make afford to invest **SURPLUSES** in profitable ways that will help the business survive. When a business does not have lots of money then there can be problems paying bills which could result in business failure.
EQUIPMENT 	When a business has **LOTS** of modern and efficient equipment (such as spreadsheets) then it may be able to more efficiently monitor and manage the finance of the business. When a business cannot afford to make use of modern equipment then work will have to be completed manually which could be slower and result in mistakes.
HUMAN RESOURCES 	When a business has **LOTS** of well trained finance staff then it can make effective financial decisions (eg where to raise more finance) which will decrease the chances of the business running out of money and failing. When a business has ineffective staff then mistakes will be made and poor financial management can result in the business having to close.
MANAGEMENT 	When a business has a **SKILLED** and **COMMITTED** financial management team then beneficial decisions about sources of finance and control of cash, profits and worth. If the financial management team is not effective then cashflow and profits will suffer and the business may face closure.

2 EXTERNAL FACTORS

Issue	Activity
POLITICAL ISSUES 	The Government may affect an organisation's finance through legislation and policies that affect the amount of payments to be covered and the amount of profit which is kept. For example, the increase in the tax rates will decrease the amount of profit left for owners.
ECONOMIC ISSUES 	Economic forces such as **INTEREST**, **UNEMPLOYMENT** and **INFLATION RATES** may affect an organisation's finance by increasing or decreasing the costs, etc. For example, inflation will make the cost of raw materials increase which may cause cashflow problems and business failure.
SOCIAL ISSUES 	The expectations and demands of the consumers in the market regularly vary and change. These factors must be constantly accounted for in the use of business finance. For example, the banking crisis in 2008 meant that society was increasingly interested in how banks were investing, and their charges and bonuses. This has meant that the way finances are managed in these businesses had to change before consumers took their money away from them.
TECHNOLOGY ISSUES 	Technology has affected finance in the following ways. • INCREASED AMOUNT OF ELECTRONIC PAYMENTS • INCREASED AMOUNT OF ELECTRONIC RECEIPTS • INCREASED USE OF SPREADSHEETS
ENVIRONMENT ISSUES 	Production processes which are environmentally friendly have become more necessary in recent years due to increasing public support for these practices and political changes. This can increase the costs and payments of a business and so could lead to cashflow problems.
COMPETITIVE ISSUES 	High levels of competition from other businesses for sales can affect the finance of a business. This is because businesses may have to lower prices to compete and so could find less cash coming in and the chance of running out of money and failing rising.