

# **HIGHER BUSINESS MANAGEMENT**



## **THE FINANCE DEPARTMENT**

### **SECTION 1**

**The importance of Financial Management to the Effectiveness of Large Organisations**

### **SECTION 2**

**Describe the Importance of Final Accounting Statements**

### **SECTION 3**

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# 1 The Importance of Financial Management to the effectiveness of Large Organisations

The efficient management of finance is vitally important to the success or failure of an organisation. The influence of the financial function is important because it has to:

- Ensure that there are adequate funds available to acquire the resources needed to help the organisation achieve its objectives
- Ensure costs are controlled
- Ensure adequate cash flow
- Establish and control profitability levels



The Finance Department exists to carry out such functions as:

- The maintenance of financial records
- Payment of salaries and wages
- The payment of bills and expenses
- The collection of accounts due
- Monitoring of business funds
- Reporting to management - to make informed judgements and decisions.

Consequently, the care and planning of the financial needs of an organisation are as necessary as the planning for operations, marketing, human resources and administration.



## Sources of Finance

Finance must be found in order for the organisation to meet its objectives.

Organisations have access to a number of different sources of finance. The source of finance an organisation chooses to use will depend on a number of factors:

- Type of organisation (ownership/sector of economy)
- Size of organisation (value of assets)
- Age of organisation (new or established business)
- What the finance is required for
- How long the finance is required for
- The cost of the Finance



Finance may be generated from inside the organisation (internal sources of finance) or from outside the organisation (external sources of finance).

### Internal Sources of Finance

| SOURCE                  | DESCRIPTION   | ADVANTAGES  | DISADVANTAGES  |
|-------------------------|---|---|--|
| <b>Retained profits</b> | Profits kept back from previous years are used to generate more profit in the future. | No interest to pay back.  | Growth may be slow if retained profits are the main source of finance. Shareholders may be unhappy as they may receive a smaller dividend. |
| <b>Sale of assets</b>   | Selling of assets (items it owns) to raise finance                                    | Assets sold that are no longer used by the business used to fund capital investment | Assets may take a long time to sell and once they are sold no revenues can be made from them   |

## External Sources of Finance

### Short Term Sources of Finance



| SOURCE                | DESCRIPTION   | ADVANTAGES  | DISADVANTAGES  |
|-----------------------|---|---|--|
| <b>Bank overdraft</b> | Withdrawing more money out of the bank than is available in the account.                                | Easy and quick to arrange.<br>Good for short periods of time to cover cash flow shortages.<br>Relatively inexpensive in the short term. | Expensive to use over a long period of time.<br>Additional charges may be incurred or the facility withdrawn if overdraft limit is exceeded. |
| <b>Trade credit</b>   | Purchasing items from a supplier where the goods are received immediately and paid for at a later date. | Gives organisation time to sell their product before the invoice is due to be paid.<br>Can help organisation's cash flow.               | Prompt payment discount is lost.<br>Failure to pay within the credit period may result in future credit being refused.                       |
| <b>Debt factoring</b> | Selling invoices (money due from debtors) to a factoring company.                                       | Organisation is guaranteed to receive a percentage of amount due.<br>Can save time/money chasing unpaid invoices.                       | Organisation does not receive full amount of invoice.<br>Factors only want to buy large value invoices/large quantity of invoices.           |
| <b>Grants</b>         | Money received from the government/EU/enterprise agencies for a specific purpose.                       | Does not need to be paid back.  | Usually has conditions attached.<br>Can take time to get as requires many forms to be completed. May not cover all costs.                    |



## Medium Term Sources of Finance

| SOURCE               | DESCRIPTION   | ADVANTAGES   | DISADVANTAGES  |
|----------------------|---|--|--|
| <b>Bank loan</b>     | Borrowing money from a bank (for a specific purpose) which is repaid over a period of time. | Repaid in fixed instalments.<br>Helps organisation to budget and plan.   | Interest is paid back on top of capital borrowed.<br>Interest rate may be high for new/high risk businesses.               |
| <b>Hire Purchase</b> | Deposit paid for item and the rest paid for in instalments.                                 | Can receive item immediately without paying in full.<br>Cost of item is spread which may make it more affordable.<br>Item is owned by organisation after final instalment is paid. | Interest could make the item expensive.<br>Item is not owned until all payments made.                                      |
| <b>Leasing</b>       | Renting vehicles or equipment for a period of time.   | Cheaper than purchasing outright in the short term.<br>Equipment is replaced when outdated.<br>May include a service contract where maintenance is included.                       | Expensive in the long term as organisation is continually paying leasing charge.<br>Organisation will never own the asset. |



## Long Term Sources of Finance

| SOURCE                 | DESCRIPTION  | ADVANTAGES   | DISADVANTAGES   |
|------------------------|--|--|---|
| <b>Mortgage</b>        | A special type of loan used to purchase property and land.   | Can be taken out over very long periods eg 25 years. Lower rate of interest than other bank loans.   | If interest rates change repayments might increase.   |
| <b>Share issue</b>     | Selling shares (a small part of the organisation). Owners of shares are known as shareholders.   | Very large sums of money can be raised. Money invested through share issue is not repaid. Shareholders have limited liability and receive dividends.                         | Cost of issuing shares can be expensive. Deciding on share price can be difficult.  |
| <b>Debentures</b>      | Loans received from private individuals or other organisations. Interest is paid over the debenture period and original value of loan paid at end of debenture period. | Very large sums of money can be raised. Organisation pays interest on the loan over the debenture period - giving them time to raise the value of the loan before it is due. | Interest will require to be paid even if organisation is making a loss. If organisation is unable to repay interest/loan the debenture-holders can sell assets to recover what is owed.                           |
| <b>Venture capital</b> | Venture capitalists provide loans to organisations that are deemed too risky by banks.   | Allows finance to be raised for risky ventures. Venture capitalist will often provide advice to ensure their investment is successful.                                       | Venture capitalists are generally only interested in large loans. Fees/interest rates can be very high. Often want share of business in exchange for finance. May want to be involved in decision making process. |

## Cash Flow Management

Cash is the most liquid of all business assets. Cash flow is all about the movement of money (cash) in and out of a business.

Liquidity - the ability to have, or have access to, sufficient cash, or near cash assets to meet the everyday commitments of running an organisation - is vital for the short-term survival of the organisation.

It is important that cash inflows (money coming into the business) are greater than cash outflows (money spent by the business), perhaps as important as the overall profit level of the organisation.

**Many businesses go into liquidation and close down because of the lack of sufficient cash to meet commitments, not because of lack of profits.**

## Cash Flow Forecasts (Cash Budgeting)

A business will use a **Cash Flow Forecast (or Cash Budget)** to make projections into the future. They will use this to **'manage' their cash and as a basis for decision making**, e.g. whether or not there will be sufficient cash to purchase fixed assets or to continue trading.



**Cash budgets** shows the estimated movements of cash in and cash out of an organisation. This can be summed up as follows:

| <b>INFLOWS</b>   | <b>OUTFLOWS</b>   |
|--|---|
| <i>Cash coming into the business</i>   | <i>Cash going out of the business</i>   |
| sale of stocks<br>sale of fixed assets<br>loans received<br>capital introduced<br>retained profits<br>decreases in debtors<br>increases in creditors | purchase of stocks<br>purchase of fixed asset<br>loans repaid<br>drawings or dividends paid<br>losses<br>increases in debtors<br>decreases in creditors |

### Uses of a Cash Budget

- Monitor and control - preparing a cash budget provides the business with a tool for comparison of budgeted with actual results obtained from other financial statements
- Measure performance of the organisation as a whole, or individual departments or sections within the organisation
- Set targets - provides targets (limits) for managers and employees to work towards
- To highlight anticipated periods of poor cash flow (deficit) and provide time for corrective action
- To highlight anticipated periods of surplus to enable organisation to invest for the future
- As part of a Business Plan which would be drawn up by a new business prior to starting up; or by an existing business prior to expansion

### Cash Budget for Mrs Sue Preme - 3 Months (April - June)

|                                     | April<br>£('000) | May<br>£('000) | June<br>£('000) |
|-------------------------------------|------------------|----------------|-----------------|
| Opening Balance (1)                 |                  |                |                 |
|                                     | 100              | 105            | 115             |
| Receipts (2)                        |                  |                |                 |
| <b>Cash Sales</b>                   |                  |                |                 |
| <b>Receipts for Credit Sales</b>    | 20               | 40             | 30              |
|                                     | <u>35</u>        | <u>30</u>      | <u>20</u>       |
| Total Receipts (3)                  |                  |                |                 |
|                                     | <u>155</u>       | <u>175</u>     | <u>165</u>      |
| Payments (4)                        |                  |                |                 |
| <b>Purchases</b>                    |                  |                |                 |
| <b>Payments of Credit Purchases</b> | 14               | 18             | 20              |
| <b>Petrol</b>                       | 2                | 3              | 4               |
| <b>Administration</b>               | 4                | 5              | 8               |
| <b>Wages</b>                        | 5                | 7              | 5               |
| <b>Rent</b>                         | 20               | 22             | 23              |
|                                     | <u>5</u>         | <u>5</u>       | <u>5</u>        |
| Total Payments (5)                  |                  |                |                 |
|                                     | <u>50</u>        | <u>60</u>      | <u>65</u>       |
| Closing Balance (6)                 |                  |                |                 |
|                                     | £105             | £115           | £100            |
|                                     | ====             | ====           | ====            |

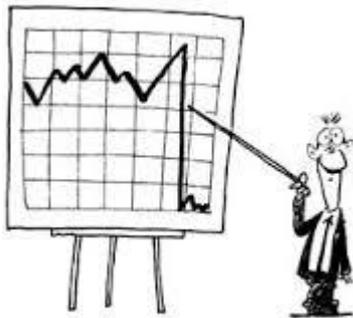
#### Notes on the Cash Budget:

- 1 Opening Balance** - The money that the organisation has at the start of the time period
- 2 Receipts** - Both cash sales and receipts from debtors are recorded as outstanding accounts are paid
- 3 Total Receipts** - Opening balance minus receipts
- 4 Payments** - All individual expenses involving the movements of cash are identified, including payments made for credit purchases
- 5 Total Payments** - The estimated total amount that will be spent during the month

6 **Closing Balance** - total income for the period minus total expenses for the period. The closing balance of one time period becomes the opening balance for the next time period. A negative balance will be bracketed. This shows a lack of cash in that month.

**POOR CASH FLOW** is caused by;

|   |   |
|---|---|
| Spending too much money on stock that has not sold.                           | Giving customers too long to pay money that they owe.                         |
| Not receiving enough money from the sale of goods and/or services.            | Not having enough time to pay bills from their suppliers.                     |
| Owners taking too much money out of the business for personal use (drawings). | Bad management decisions eg high marketing spend that doesn't generate sales. |



Possible courses of action to **IMPROVE CASHFLOW**:

|   |   |
|---|---|
| Reconsider expenses - can anything be cut back? Eg are all employees required, find a cheaper supplier/supplier who will give a discount. | Spread cost of large capital purchases by purchasing through hire purchase or by leasing equipment.                     |
| Increase sales revenue by increasing selling price or carrying out additional advertising to increase amount sold.                        | Inform the bank of any shortage and organise an overdraft in advance.   |
| Offer discounts to customers who pay on time as this will encourage them to pay more quickly.   | Sell equipment or machinery no longer needed as this will bring in cash to be used to fund other areas of the business. |
| Obtain additional finance eg a loan.  | Obtain trade credit from supplier.  |
| Reduce level of trade credit given to customers.  | Raise extra capital by investing retained profits or issuing new shares.  |



## Cash Budgets and Their Importance to the Role of Management

Using the roles of management, as described by Henri Fayol, we can see just how useful Cash Flow Statements can be as a management tool:

|              |   |
|--------------|---|
| Plans        | Looks ahead and sets aims and strategies. By identifying where cash is being spent and where it is being earned, management can plan to borrow, either to finance short-term cash flow problems or to finance long-term expansion.  |
| Organises    | Make arrangements for all the resources of the organisation to be in the right place at the right time and in the right quantities. Quite obviously such resources have to be financed, and management must be able to ensure that it can afford the resources it requires and takes full advantage of bulk purchase discounts, trade credit and other financial incentives.            |
| Commands     | Tells subordinates what their duties are. It is essential for the efficient running of the organisation that each department is given a budget for expenditure on routine requirements. Each department must also know its limits when making one-off requests for additional finance for specific jobs, projects or capital expenditure.   |
| Co-ordinates | Make sure everyone is working towards the same aims and that the activities of individual workers fit in with the work of other parts of the organisation. Financial reports and summaries from each department will allow management to keep a clear overview of the operation as a whole. It may be that surpluses in one department can be used to offset short-falls in another.    |
| Controls     | Measures, evaluates and compares results with plans, and supervises and checks work done. Using Cash Budgets as a measure of performances or progress gives management a tool that records quantifiable data that is the same for each department.  |
| Delegates    | Makes subordinates responsible for tasks and gives them the authority to carry them out. This can involve delegating responsibility for holding, recording and spending departmental budgets or project budgets to the departmental manager or project leader. It can even be done simply by giving a cashier full control of, and responsibility for, her /his own cash point or till. |
| Motivates    | Encourages others to carry out their tasks effectively, often by introducing team-work, empowerment, worker participation in decision-making and other non-financial methods. This can come from appropriate delegation where the individual(s) feel(s) trusted and empowered because of being responsible for finance within their area of control.                                    |

## 2 Describe the purpose of Final Accounting Statements

At the end of an accounting period businesses produce statements to show how much **profit/loss they have made in that period** and to show the **value of the business at the end date**.

In order that data contained in these records can be **communicated in a recognisable form** to all stakeholders, items of a similar nature are gathered together and reported in **standard Financial Statements**.

These statements are:

- **Income Statement**  
(The Trading Profit and Loss Account)
- **Statement of Financial Position**  
(The Balance Sheet)



These statements provide information relating to a particular aspect of the organisation's activities during a trading period - most commonly one financial year. These financial statements are often referred to as the final accounts of the business.

These can be used to compare against **past years performance** or **similar business organisations** or **projected targets**.

## The Trading Account

This account shows the profit made from buying and selling goods and services. It compares the value of sales to the customer with the value of the sales at cost price.

The main activity of any organisation involved in trading is the purchase of the goods and the subsequent selling-on of those goods to the customer at a higher price.

The difference between Sales Value (turnover) and the Cost of Sales is the Gross Profit.

Items that may appear in the trading account include:

- Sales (sometimes shown as Turnover)
- Purchases
- Returns Inwards (sales returns) and Returns Outwards (purchase returns)
- Carriage inwards (the cost of bringing stock into the shop/warehouse)
- Warehouse rent (this is part of the cost of sales as it is a charge against the storage of stock)
- Stock at the start of the trading period (opening stock)
- Stock at the end of the trading period (closing stock)

In fact, the Trading part of the Trading Profit and Loss Account details any item that relates to the sales or the cost incurred when making those sales.

Let us look at a worked example:

The following balances, at 31 August 2014, were extracted from the books of the sportswear shop 'Jogging Along' to prepare the Trading Account;

|                                    | £       |
|------------------------------------|---------|
| Sales                              | 104,285 |
| Purchases                          | 45,628  |
| Returns Inwards (sales returns)    | 531     |
| Returns Onwards (purchase returns) | 135     |
| Stock at Start (1 September 20-1)  | 5,432   |
| Stock at End (31 August 20-2)      | 6,102   |
| Carriage Inwards                   | 365     |



### Trading Account for Jogging Along for year ended 31 August 2014

|                                    | £          | £             | £                |
|------------------------------------|------------|---------------|------------------|
| Sales (1)                          |            |               |                  |
| Sales (turnover)                   |            |               | 104,285          |
| Less returns inwards               |            |               | <u>531</u>       |
|                                    |            |               | 103,754          |
| <b>Less Cost of Goods Sold (2)</b> |            |               |                  |
| Opening Stock                      |            | 5,432         |                  |
| Add: Purchases                     | 45,628     |               |                  |
| Carriage inwards                   | <u>365</u> |               |                  |
|                                    | 45,993     |               |                  |
| Less returns outwards              | <u>135</u> |               |                  |
|                                    |            | <u>45,858</u> |                  |
| Cost of good available for sale    |            | 51,290        |                  |
| Less Closing Stock                 |            | <u>6,102</u>  |                  |
| Cost of Goods Sold                 |            |               | <u>45,188</u>    |
| <b>GROSS PROFIT (3)</b>            |            |               | £58,566<br>===== |

## The Profit and Loss Account

The Profit and Loss Account calculates the final profit or loss that an organisation has made over a financial time period.



It starts with the *Gross Profit* figure from the Trading Account, and lists any items of additional revenue raised by the organisation as well as any expenses incurred by the organisation *not directly linked to trading*.

Items that will appear in the Profit and Loss Account include:

### **Additional Income (added to the Gross Profit)**

- Discounts received
- Commission received
- Profit on the disposal of assets (things of value that the firms owns and then sells)

### **Expenses (subtracted)**

- Wages
- Carriage outwards (dispatching goods to customers)
- Rent
- Rates
- Insurance
- Advertising
- Bad debts allowance



- Depreciation (the appropriation of the cost of an asset over its economic lifetime)
- Telephone
- Stationery
- Any other general expenses



**Let's look at a worked example:**

The following balances, at 31 August 2014, were extracted from the books of the sportswear shop 'Jogging Along' to prepare the Trading Profit and Loss Account;

**Trading, Profit and Loss Account for Jogging Along for the year ended 31 August 2014**

|                                    | £          | £             | £             |
|------------------------------------|------------|---------------|---------------|
| Sales (1)                          |            |               |               |
| Sales (turnover)                   |            |               | 104,285       |
| Less returns inwards               |            |               | <u>531</u>    |
|                                    |            |               | 103,754       |
| <b>Less Cost of Goods Sold (2)</b> |            |               |               |
| Opening Stock                      |            | 5,432         |               |
| Add: Purchases                     | 45,628     |               |               |
| Carriage inwards                   | <u>365</u> |               |               |
|                                    | 45,993     |               |               |
| Less returns outwards              | <u>135</u> |               |               |
|                                    |            | <u>45,858</u> |               |
| Cost of good available for sale    |            | 51,290        |               |
| Less Closing Stock                 |            | <u>6,102</u>  |               |
| Cost of Goods Sold                 |            |               | <u>45,188</u> |
| <b>GROSS PROFIT (3)</b>            |            |               | £58,566       |
| <b>Less expenses (4)</b>           |            |               |               |
| Wages                              |            | 26,390        |               |
| Carriage Outwards                  |            | 560           |               |
| Rent                               |            | 4,400         |               |
| Rates                              |            | 1,400         |               |
| Insurance                          |            | 600           |               |
| Advertising                        |            | 2,000         |               |
| General Expenses                   |            | 1,354         |               |
| Telephone                          |            | <u>460</u>    |               |
|                                    |            |               | <u>37,164</u> |
| <b>NET PROFIT (5)</b>              |            |               | £21,402       |
|                                    |            |               | =====         |

## Notes on the Trading Profit and Loss Account

### 1 Sales or Turnover

The revenue from selling goods and/or services.



### 2 Cost of Sales

Costs associated directly with the production/purchase of goods or services. (Warehousing costs are traditionally shown in the Trading Account.)

### 3 Gross Profit/Loss

This is the difference between Sales revenue and Cost of Goods Sold. This money has arisen directly from the trading activities of the organisation.

### 4 Expenses

All additional expenses incurred by the organisation, for example administration, distribution and selling expenses are listed here.

### 5 Net Profit

This is the amount of money the organisation has left once all expenses have been deducted from the sales revenue received. (In Partnerships and Limited Company final accounts the Net Profit figure is given before tax charges have been deducted. Such charges will be recorded in a Profit Appropriation Account, where the users of financial information will be able to see exactly what has happened to the profits of a business).



# Statement of Financial Position

## (The Balance Sheet)

The Trading, Profit and Loss Account records the history of the business activity throughout the financial year, whereas the Balance Sheet shows a "snapshot" at a particular date in time.

The Balance Sheet shows the assets of an organisation (what it owns) and its liabilities (what it owes to others) at this point in time.



In particular the Balance Sheet shows:

- The value of the organisation's assets (Fixed and Current), for example premises, vehicles, machinery, equipment, stock, debtors, bank account balances, cash
- The liabilities (Current and Long-term) of the organisation, for example capital, creditors, bank loans
- The equity/capital of the company, for example, share value, reserves (how it is financed)

The Balance Sheet records the financial worth of the business at a particular point in time. Therefore, a Balance Sheet is out of date by the time it is published. It forms part of the historical accounting records of a business.

As the name of the accounts suggests, both sides of the account will "Balance" due to the accounting equation:

$$\text{CAPITAL} = \text{ASSETS} - \text{LIABILITIES}$$



**A typical Balance Sheet for a Limited Company would look like this:**

Jeff Capes Haulage Contractor Ltd - Balance Sheet as at 31 August 2014

|  | £            | £             | £              |
|--|--------------|---------------|----------------|
| Fixed Assets (1)                                 |              |               |                |
| <b>Premises</b>                                  |              |               | 130,000        |
| <b>Machinery</b>                                 |              |               | 30,000         |
| <b>Vehicles</b>                                  |              |               | <u>19,000</u>  |
|  |              |               | <b>179,000</b> |
| <br>Current Assets (2)                           |              |               |                |
| <b>Stock</b>                                     | 27,000       |               |                |
| <b>Debtors</b>                                   | 13,000       |               |                |
| <b>Bank</b>                                      | <u>7,000</u> | 47,000        |                |
| <br>Less Current Liabilities (3)                 |              |               |                |
| <b>Trade creditors</b>                           | 8,000        |               |                |
| <b>Dividends</b>                                 | 2,000        |               |                |
| <b>Tax</b>                                       | <u>2,000</u> | <u>12,000</u> |                |
| <br>NET CURRENT ASSETS (4)                       |              |               | <u>35,000</u>  |
| <b>(Working Capital)</b>                         |              |               |                |
| <br>NET ASSETS (5)                               |              |               | £214,000       |
| <b>(Capital Employed)</b>                        |              |               | =====          |
| <br>Financed by:                                 |              |               |                |
| <b>Issued share capital (6)</b>                  |              |               | 105,000        |
| <b>Reserves from Profit and Loss Account (7)</b> |              |               | <u>29,000</u>  |
| <b>Shareholders' Interest (8)</b>                |              |               | 134,000        |
| <b>(Shareholders' Funds)</b>                     |              |               |                |
| <br>Add Long-Term Liabilities (9)                |              |               | <u>80,000</u>  |
|  |              |               | £214,000       |
|  |              |               | =====          |

Both sides of the Balance Sheet should agree



## Notes on the Balance Sheet for a Limited Company

1 **Fixed Assets** - Items owned by the organisation that will generate income, such as property, equipment, furniture, vehicles, etc. Without these assets the organisation would not be able to operate.

2 **Current Assets** - Items owned by the organisation that will be used up, sold or converted into cash within twelve months. They include stocks, debtors, bank balances and cash itself.



3 **Current Liabilities** - These are debts owed to outside organisations that must be repaid in the short term, usually, in less than twelve months. They include creditors (suppliers), bank overdraft, dividends due to shareholders and taxation.

4 **Net Current Assets (Working Capital)** - The amount by which the total value of current assets exceeds the total value of current liabilities. (It should always be the case that the value of the current assets is greater than the value of current liabilities. If this is not so, then the organisation may be facing serious cash flow problems. The only way that it could then repay its short-term debts would be to incur more debt, or to sell some of its fixed assets, thereby reducing its ability to continue operations at their present level.)

5 **Net Assets (Capital Employed)** - Net fixed assets + net current assets. This shows the net value of the firm once - short-term debts have been repaid.

6 **Issued Share Capital** - Money put into the organisation by the owners or shareholders. In return for their investment they receive dividend payments (a share of the profit), the amount being proportion to the size of their shareholding.



- 7 **Reserves from Profit and Loss Account** - These are profits retained by the organisation after the payment of dividends to the shareholders and after provision has been made for all other current liabilities. Organisations will use these profit reserves to finance expansion at some later date.
- 8 **Shareholders' Interest (Shareholders' Funds)** - All of the issued share value (ordinary and preference shares), all reserves, retained profits and any other reserves.
- 9 **Long-Term Liabilities** - Debentures or other long-term loans such as mortgages where the debt repayment is not due within the next twelve months.

## Interpretation of the Trading, Profit and Loss Account and Balance Sheet

All public and private companies are required to provide financial statements (final accounts) at the end of each trading period. These accounts are of interest to the Inland Revenue, which uses the information to determine the tax payable by the organisation.

Sole traders, partnerships and private companies are **not legally required to make public their final accounts**, although many are forced to provide these when attempting to borrow from banks or other financial institutions.



However, **Public Limited Companies**, which obtain money by issuing shares, are **legally obliged to publish their final accounts**.

Many people, including rival companies, investors, lenders and trade union representatives, use the information contained in published accounts.



Careful study of final accounts can provide an enormous amount of information about the performance of an organisation. For example, it is possible to examine the Trading Account and discover more than just the *Gross Profit* figure. By interpreting the data available and making comparisons with figures for previous years, or with similar organisations, or by analysing the relationship between different figures, it is possible to find the real indicators of the future success and financial security of an organisation.

The types of questions that can be answered by interpretation of the final accounts include:

### Interpretation of Trading Profit and Loss Accounts

- Was this year's trading result good or bad, compared with last year or with a rival company?
- Are we making efficient use of our stock?
- Has the Gross Profit improved this year, compared with last year?
- Does our Net Profit figure compare favourably with those of other organisations in the same industry?



### Interpretation of Balance Sheets

- Do we have enough working capital to avoid cash flow problems?
- Are we making enough use of available trade credit?
- Is our level of debtors comparable with that of our industry competitors?
- How much is the business worth



## The Uses and Limitations of Ratio Analysis

Final Accounts can be long and complicated documents. To make it **easier to compare figures** the raw figures are **changed to percentages and ratios** to make **comparison easier** in the same way exams are marked.

Information obtained from the final accounts of an organisation (Trading, Profit and Loss and Balance Sheet) can be analysed through the use of common ratios.

- **PROFITABILITY** - measure an organisation's ability to control its spending (so it is earning more than it is paying out)
- **LIQUIDITY** - measure an organisation's ability to pay their short-term debts
- **EFFICIENCY** - measure an organisation's ability to make good use of their resources

### Uses of Ratio Analysis

- To compare the current year's performance with that of previous years.
- To compare our performance with those of similar organisations (same type and size).
- To interpret information in order to identify why differences occur and how best to improve performance in the future.
- To use the information for forecasting/budgeting.
- Comparisons are important in order that a true picture of the business performance can be drawn up. This also means that management can make informed decisions about the future of the business, based on reliable information.

## Limitations of Ratio Analysis

- Information contained in final accounts is historical - it happened in the past.
- Like must be compared with like - any comparisons made must be with firms of similar size and in the same type of industry.
- Findings may not take into account external factors, recession or inflation effects.
- Findings do not reflect the implications or effects of new policies.
- Using different methods of stock valuation can result in different VALUE figures from company to company or from time period to time period.
- Only covers financial information. Does not take into account any other factors like the quality of staff or location of the business.

## Profitability Ratios



### Gross Profit Percentage

|                     |   |
|---------------------|---|
| <b>Formula</b>      | $\frac{\text{Gross Profit}}{\text{Net Sales (Turnover)}} \times 100$  |
| <b>Purpose</b>      | <ul style="list-style-type: none"> <li>to measure the percentage of gross profit earned on the trading activities of the organisation</li> <li>to measure how many pence Gross Profit is earned out of every £ of sales.</li> </ul>   |
| <b>Used by</b>      | <ul style="list-style-type: none"> <li>managers/directors, comparing year on year and other similar companies.</li> </ul>   |
| <b>Limitations</b>  | <ul style="list-style-type: none"> <li>no comment can be made unless trends over different time periods, or comparisons with other similar organisations are made.</li> </ul>   |
| <b>Improvements</b> | <ul style="list-style-type: none"> <li>cut the costs of production/manufacture</li> <li>purchasing cheaper goods/raw materials</li> <li>Reduce wastage of stock.</li> <li>Reduce theft of stock.</li> <li>increase the selling price to the consumer to increase sales revenue</li> </ul> |

## Net Profit Percentage

|                     |   |
|---------------------|---|
| <b>Formula</b>      | $\frac{\text{Net Profit}}{\text{Net Sales (Turnover)}} \times 100$  |
| <b>Purpose</b>      | <ul style="list-style-type: none"> <li>• to measure the Net Profit earned as a percentage of the sales, after all expenses have been met.</li> <li>• to measure how many pence net profit is earned out of every £ of sales.</li> </ul> |
| <b>Used by</b>      | <ul style="list-style-type: none"> <li>• managers/directors/current investors/Inland Revenue, comparing year on year and other similar companies.</li> </ul>  |
| <b>Limitations</b>  | <ul style="list-style-type: none"> <li>• no comment can be made unless trends over different time periods/comparisons with other similar organisations are made.</li> </ul>   |
| <b>Improvements</b> | <ul style="list-style-type: none"> <li>• reduce the proportion of expenses paid out of every £1 of turnover.</li> <li>• Reduce wastage of stock.</li> <li>• Reduce theft of stock.</li> <li>• Increase the Gross Profit</li> </ul>      |



## Return on Capital Employed

|                     |  |
|---------------------|--|
| <b>Formula</b>      | $\frac{\text{Net Profit before interest and tax}}{\text{Capital Employed (at start)}} \times 100$  |
| <b>Purpose</b>      | <ul style="list-style-type: none"> <li>to measure the percentage return on the capital invested in the business.</li> </ul>  |
| <b>Used by</b>      | <ul style="list-style-type: none"> <li>Managers - how useful is the capital employed in generating profits?</li> <li>Current investors - what rate of return is being given on capital invested?</li> <li>Potential investors - is the return from this company better/worse than from other companies? (Comparisons year on year and with other similar companies.)<br/>Comparison with current interest rates on Savings Accounts - far safer investment.</li> </ul> |
| <b>Limitations</b>  | <ul style="list-style-type: none"> <li>this ratio uses <i>historic</i> costs of the business's assets. If asset values are inaccurate then the capital employed figure will also be inaccurate.</li> </ul>   |
| <b>Improvements</b> | <ul style="list-style-type: none"> <li>Improve Net Profit (reduce cost of expenses)</li> <li>Improve productivity of staff</li> </ul>  |

## Liquidity Ratios

### Current Ratio (also called the Working Capital Ratio)

|                     |  |
|---------------------|--|
| <b>Formula</b>      | $\frac{\text{Current Assets}}{\text{Current Liabilities}}$ shown as something : 1    eg. 2.1 : 1   |
| <b>Purpose</b>      | <ul style="list-style-type: none"> <li>to measure whether the business has sufficient current assets to cover payment in full of current liabilities. Has the firm enough 'working capital' to meet all short-term debts?</li> <li>Compares assets that will become liquid in less than twelve months with liabilities that fall due in the same time period.</li> </ul>   |
| <b>Used by</b>      | <ul style="list-style-type: none"> <li>managers/directors/banks and other lenders, comparisons year on year and between companies.</li> </ul>  |
| <b>Limitations</b>  | <ul style="list-style-type: none"> <li>there is no ideal ratio, through it is commonly accepted that this ratio should be 2:1. (Some businesses prosper with a ratio of less than this.)</li> </ul>  |
| <b>Improvements</b> | <p><b>More than 2 : 1</b>                      Too much cash tied up in <b>current assets</b></p> <p>In this situation the <b>business must think about:</b></p> <ol style="list-style-type: none"> <li><b>Reducing the amount of stock</b> and cash held.</li> <li><b>Investing in fixed assets</b> that will make the company a return eg new machinery.</li> <li><b>Spend more on research and development</b> or advertising to increase their market share</li> </ol> |

**Less than 2 : 1 Liquidity problem.** This can lead to bankruptcy not have **enough assets to pay for liabilities.**

In this situation the **business must think about:**

- 1 **Reducing** the amount of **liabilities** that the company has
- 2 **Increase current assets** eg stock, cash
- 3 **Restricting spending.**



## Acid Test (Quick) Ratio

|                     |  |
|---------------------|--|
| <b>Formula</b>      | $\frac{\text{Current Assets} - \text{Stock}}{\text{Current Liabilities}}$ <p>shown as something : 1 eg. 2.1 : 1</p>  |
| <b>Purpose</b>      | <ul style="list-style-type: none"> <li>• to measure if the company has sufficient liquid assets to cover current liabilities, if required</li> <li>• to assess if the company is suffering from a cash flow problem</li> <li>• this ratio excludes the values of stocks in its calculation as it can be quite difficult to dispose of stocks in the very short term. Even if stocks could be disposed of immediately, the business could no longer continue as it would have no stock left to trade with!</li> </ul> |
| <b>Used by</b>      | <ul style="list-style-type: none"> <li>• managers/directors/bank and other lenders</li> </ul>  |
| <b>Limitations</b>  | <ul style="list-style-type: none"> <li>• if a business has a slow stock turnover, the acid test ratio should, ideally, be greater than 1:1. Only shows the figures and not the reasons for the rate.</li> </ul>  |
| <b>Improvements</b> | <p>Hold less Stock<br/>Increase the rate of Turnover</p>   |

## Efficiency Ratios

### Rate of Stock Turnover

|                     |  |
|---------------------|--|
| <b>Formula</b>      | $\frac{\text{Cost of Goods Sold}}{\text{Average Stock}^*}$ <p>*(opening stock + closing stock)/2</p>   |
| <b>Purpose</b>      | <ul style="list-style-type: none"><li>• to measure how often the business buys in a 'bundle' of stock in the accounting period</li></ul>   |
| <b>Used by</b>      | <ul style="list-style-type: none"><li>• Managers - how much money is tied up in stock which could be used elsewhere.</li><li>• managers/directors/banks and other lenders, comparisons year on year and between companies.</li></ul>             |
| <b>Limitations</b>  | <ul style="list-style-type: none"><li>• There is no ideal figure to compare, although a lower figure shows that stock is being purchased infrequently and likely in high quantities. The figure should be appropriate for the product.</li></ul> |
| <b>Improvements</b> | <ul style="list-style-type: none"><li>• Buy in smaller quantities of stock more frequently</li><li>• Increase sales</li></ul>  |



### 3 Users of Financial Information in Business

Financial information is used for a wide variety of purposes by different stakeholders of the business.

#### Controlling Costs and Expenditure

Managers and owners can use profitability ratios to investigate and decide which costs should be monitored and dealt with.

These ratios can also be used to decide whether suitable prices are being charged for the items of stock. If the ratios are too low, the prices can be raised. However, this may lead to customers going elsewhere.



Managers and owners can also use the profitability ratios to decide whether the profits are high enough to reward workers by giving them bonuses at the end of the year.

#### Forecasting Trends and Planning for the Future

Businesses can use ratios to forecast trends from year to year. They can see which areas of the business are affecting profits, e.g. cost of purchases, administrative costs, wages, or revenue earned for sales.



Managers can use cash flow to forecast trends. This helps them to identify whether:

- Proposed increased wage costs would lead to them having to arrange an overdraft
- The proposed purchase of a computer would mean having to arrange a loan.

Financial information about the business along with information collected on competitors can be used to consider introducing something new. This could be new products or new methods of production or selling, for example, on the internet.

## Monitor Performance

Managers can use final accounts and ratios to monitor performance by comparing profits from year to year or with other similar organizations.

They can also ensure that targets and objectives are being met eg sales levels, profitability, and production levels.



## Stakeholders uses of Financial Information

Central to the work of an accountant is the provision of information that can be given to interested parties to assist them in making decisions.

### Managers/Owners

Firstly, require measures of profit to *evaluate* the effects of past decisions and how well they achieved the organisational goals, and as a *guide* assist in the decision-making process for the next financial period.



Secondly, they need to know the patterns of cash flows, both historical and current and to be able to *predict* and *maintain* liquidity and credit worthiness.

Thirdly, they need to have detailed information about the organisation's assets and liabilities to assist in the *control* of them.

Fourthly, management will use financial information to control the actions of employees. The information required by the management team is more detailed and is required more frequently, than by any other user group.

## Shareholders

Shareholders are interested in the profits of the organisation as this may influence dividend payments. They will be interested in its liquidity and continued success.



## Employees

Take an increasing interest in the financial affairs of the organisations that employ them. Although the ability to pay has not been *accepted* fully as a criterion for wage settlements, in recent years there has been increasing use of company and industry profit figures in wage negotiations. Many wage settlements are now also linked to productivity (and thereby profit) improvement.

Employees may use information on profit levels to see if bonuses may be paid and to satisfy themselves that there is job security.



## Investors and Potential Investors



Will want to use information on past performance and the present financial position of an organisation to attempt to *predict* future returns on capital invested. They will also use accounting information to *assess* the performance of the management team.

## Local Community

Success/survival of organisation may bring more jobs to the area and boost the local economy. This in turn may require the local council to look at profit levels of the organisation to estimate growth potential and the need for additional facilities in the area eg housing and schools.

## Creditors

Both short-term (suppliers) and long-term (institutional and individual lenders) have an obvious interest in assessing the amount of security for the debt owed to them. They will be interested in the organisation's ability to generate funds to repay capital amounts outstanding *and* to repay, on a regular basis, any interest owing. Creditors will also want to know the extent and priority of any other liabilities.

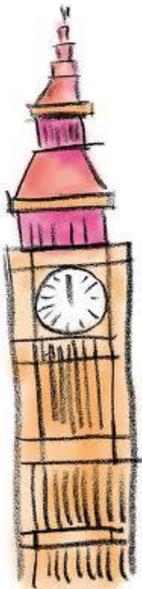


## Trade Unions

Re-presenting groups of employees, trade unions will use financial information to try to negotiate the 'best deal' for their members, in terms of pay and working conditions. Unions are vociferous in condemnation of high salary increase for senior management and low wage settlements for workers. They also have influence in the political sphere, having a close association with the Labour Party, and may use/provide financial information to support their, or the Labour Party's aims.



## Government and Government Bodies



These institutions must be provided with certain information *by law* regarding the financial position of an organisation - even a sole trader must provide a record of profit and expenses to the Inland Revenue for taxation purposes. The requirements for companies will normally be laid out in the Companies Act.

The increasing importance of consumer protection has meant that, more and more, financial information is required to highlight 'problem' areas such as unfair pricing. The June 1994 case against the UK music industry over the high prices charged for CDs was not proved as unfair. It is also used to identify restrictive practices, to prevent the operation of cartels and the growth of monopolistic manufacturers and retailers and to identify foreign investment (especially in 'key' industries).

## Economists/Analysts

Use accounting data as a basis for their research and to provide information for the planning and prediction of industry, as well as national and international economic performance. Much of their research is used by government (and the opposition parties) to assist in policy-making decisions for the business community as a whole.



## Customers & the General Public

The general public have, in recent years, taken an increasing interest in the effects of business activities. Consumers, as shareholders (Margaret Thatcher's 'popular capitalism') and as members of wider society and as environmentalists, more and more want to know about issues such as monopolistic profits, harmful and dangerous products, pollution, unfair/offensive advertising and foreign control. In terms of Public Limited Companies much of this information can be found in the published accounts and reports - which must be made available, on request, to members of the public.



## Limitations of Financial Analysis

- Financial statements are *historic*
- Using different methods of stock valuation can result in different *value* figures from company to company or from time period to time period
- Unless looking at percentage figures, the impact of inflation is not reflected in comparative figures
- There can be international variations in accounting standards
- Valuing *intangibles*, such as 'Goodwill' is subjective, not objective

Financial statements only include quantifiable data. Important points not included in financial data are:

- Morale/staff turnover
- Product portfolio
- Abilities/skills/expertise of staff

- Research and development/new product development
- Technological sophistication of product/production process
- Competition/size/share of market
- Marketing techniques used
- Organisation structure
- Social concerns/duties



#### **4 Role of Technology in Managing Finance**

Technology can assist greatly in the preparation and interpretation of financial records, in particular spreadsheets (eg MS Excel) and accounting packages (eg Sage).

- Spreadsheets allow a variety of formulae and functions to prepare financial records - this may reduce errors made during calculations
- If statements can be used to see the outcome of alternatives - can help managers make decisions eg by showing effect of borrowing different levels of finance in a cash budget
- Templates can be created and used throughout the organisation to ensure consistency of financial record keeping - makes internal analysis easier and helps employees understand/use spreadsheets effectively
- Graphs and charts can be created from spreadsheets which are easy to understand - comparison of projected/actual figures, trends over a period of time, comparison with competitors
  - Graphs/charts may be inserted into financial reports that can be emailed to appropriate staff or added to presentations (eg MS Powerpoint) to communicate financial information

- Spreadsheets can be stored centrally in the organisation's intranet allowing multi-user access and can be backed-up in case original file is damaged/lost