Financial information and decisions

Why businesses need finance and where it comes from, cash-flow forecasts and working capital, profit and income statements, the statement of financial position, and profitability and liquidity ratios.

Money decides whether a business survives. This chapter covers **where finance comes from**, **how to plan cash**, and **how to read a business's accounts**.

5.1 Business finance: needs and sources

Why businesses need finance

- **Start-up capital**: money to set up (premises, equipment, stock).
- **Capital for expansion**: new premises, machines, products.
- **Working capital**: money to pay **day-to-day costs** (wages, suppliers, bills) until customers pay.

Short-term finance is needed for **less than a year** (to fund stock or cover a gap in cash). **Long-term finance** is for **more than a year** (buying property or machinery).

Sources of finance

	Internal	External
Meaning	from **within** the business	from **outside** the business
Examples	**retained profit**, **sale of assets**, owner's savings, reducing stock	**bank loans**, **overdraft**, **share issue**, **trade credit**, **leasing**, **debentures**, grants

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	Source	Notes
Short-term	**Overdraft**	the bank lets the account go below zero up to a limit; flexible, but a **high interest rate** and can be withdrawn
	Trade credit	delaying payment to suppliers (e.g. 30 days); free, but can lose discounts
	Factoring (selling debts)	immediate cash for unpaid invoices
Long-term	**Debt**: **bank loan** or **debentures**	must be **repaid with interest**, keeps ownership, but interest is a cost whatever the profit
	Equity: **selling shares**	no repayment or interest, but **owners' control is diluted** and dividends are paid; only limited companies
	Retained profit	cheap, no interest, but only available if the business has made profit
	Leasing	use an asset for a fee instead of buying; no big outlay, but **no ownership** and total cost may be higher

Alternative sources of capital: **micro-finance** (very small loans to people, often in developing countries, who cannot get bank loans) and **crowd-funding** (many people each give a small amount, usually through a website, in exchange for a reward or a share).

Factors considered when choosing: **size and legal form** (a sole trader cannot sell shares), the **amount** needed, the **length of time** (a long-term asset needs long-term finance), **cost** (interest), **existing loans**, **risk** and **control**.

> **Recommend and justify finance: match the time (short-term needs, short-term source; long-term assets, long-term source), the amount and cost, and the type of business, then say why another source is weaker.**

5.2 Cash-flow forecasting and working capital

Why cash matters

Cash is the money a business has **available to spend**. A business can be **profitable and still fail** if it **runs out of cash** to pay bills. **Profit and cash are different**: profit is revenue minus costs over a period (and may include sales not yet paid), while cash is the actual money in hand.

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The cash-flow forecast

A **cash-flow forecast** is an estimate of the **cash coming in (receipts)** and **going out (payments)** each month, and the **resulting balance**.

	Jan	Feb	Mar
Opening balance	2,000	1,500	600
Cash inflows (sales, loans)	8,000	9,000	12,000
Cash outflows (wages, stock, rent)	8,500	9,900	10,500
Net cash flow (inflows – outflows)	**–500**	**–900**	**+1,500**
Closing balance (opening + net)	**1,500**	**600**	**2,100**

> **Net cash flow = total inflows – total outflows. Closing balance = opening balance + net cash flow. The closing balance of one month becomes the opening balance of the next.**

Importance: shows **when cash shortages are likely** so action can be taken, helps persuade **banks** to lend, helps plan spending and **spot problems early**.

Amending a forecast: if a figure changes (sales fall by $500 in March), recalculate that month's inflows, net cash flow and closing balance, **and every month after** (because each opening balance depends on the previous closing balance).

Interpreting: look for **negative balances** (cash shortage), the **months with high outflows**, and whether the **closing balance is increasing or decreasing**. **Limitations**: it is only an **estimate** (sales may be wrong; unexpected costs appear).

Overcoming a short-term cash problem: arrange an **overdraft**, **delay paying suppliers** (use trade credit), **ask debtors to pay more quickly**, **cut spending or delay purchases**, sell **unused assets**, or sell stock at a discount.

Working capital

Working capital is the money available for **day-to-day running costs**.

> **Working capital = current assets – current liabilities.**

It is important because without enough, a business cannot pay **suppliers and wages** on time and may fail. Too much working capital is wasteful (cash sitting idle or too much stock).

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5.3 Income statements

Profit

Profit = **revenue – total costs**. A business makes profit by **selling at more than it costs to produce**.

Importance of profit to private-sector businesses: **reward for risk-taking and enterprise** (owners), a **source of finance** (retained profit for growth), a sign of success and a **measure of performance**, and the way to pay **dividends** to shareholders.

Profit and cash differ: profit includes **sales on credit** that have not yet been paid, and costs like **depreciation** that do not involve cash leaving the business.

The income statement

An **income statement** (profit and loss account) shows **revenue, costs and profit** over a period (usually a year).

	$
Revenue (sales)	200,000
Cost of sales (cost of goods sold)	**(120,000)**
Gross profit	**80,000**
Expenses (wages, rent, advertising, interest)	(50,000)
Profit (before tax)	**30,000**
Tax	(6,000)
Profit after tax	24,000
Dividends paid	(10,000)
Retained profit	**14,000**

> **Gross profit = revenue – cost of sales. Profit = gross profit – expenses. Retained profit is what stays in the business after tax and dividends.**

Decision-making: compare profit with the previous year or with competitors, identify costs that are rising, or decide whether to raise prices or cut expenses. (You will not be asked to construct an income statement, but you must read and use one.)

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5.4 Statement of financial position

The **statement of financial position** (balance sheet) shows what a business **owns (assets)** and **owes (liabilities)** at **one date**, and how it is **financed**.

Classification	Meaning	Examples
Non-current assets	assets kept for **more than a year**	buildings, machinery, vehicles
Current assets	assets that become cash **within a year**	**inventories**, **receivables (debtors)**, cash
Current liabilities	debts to repay **within a year**	**payables (creditors)**, overdraft, tax owed
Non-current liabilities	debts to repay **after more than a year**	long-term bank loans, debentures
Equity (capital)	the owners' stake: share capital and retained profit	

> **Net assets = total assets – total liabilities = owners' equity. Both sides balance: what the business owns (assets) equals what it owes to others plus the owners' stake.**

Interpreting: see **how the business is financed** (mostly by loans, which is risky, or by the owners' funds), **what assets it owns**, whether **current assets cover current liabilities** (liquidity) and how much is **tied up in inventories**. **Selling inventories** is a way to raise cash quickly. (You will not be asked to construct a statement of financial position.)

5.5 Analysis of accounts

Profitability is how much profit a business makes **compared with** its sales or capital. **Liquidity** is its ability to **pay short-term debts** when they are due. A business can be profitable but not liquid.

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Ratios

Ratio	Formula	What it shows
Gross profit margin	**gross profit ÷ revenue × 100**	profit left from each $100 of sales after direct costs
Profit margin	**profit ÷ revenue × 100**	profit from each $100 of sales after **all** costs
Return on capital employed (ROCE)	**profit ÷ capital employed × 100**	profit **relative to money invested**; compare it with the interest rate on savings
Current ratio	**current assets ÷ current liabilities**	ability to pay short-term debts; **about 1.5 to 2** is often seen as healthy
Acid test ratio	**(current assets – inventories) ÷ current liabilities**	stricter measure that **excludes inventories**; **about 1 or more** is often seen as safe

TRY IT

Revenue $400,000, gross profit $160,000, profit $48,000, capital employed $300,000. **Gross profit margin** = 160,000 ÷ 400,000 × 100 = **40%**. **Profit margin** = 48,000 ÷ 400,000 × 100 = **12%**. **ROCE** = 48,000 ÷ 300,000 × 100 = **16%**.

TRY IT

Current assets $90,000 (inventories $40,000), current liabilities $60,000. **Current ratio** = 90,000 ÷ 60,000 = **1.5**. **Acid test** = (90,000 – 40,000) ÷ 60,000 = **0.83**. The business may struggle to pay its short-term debts without selling inventories.

To improve ratios: raise **profit margin** by increasing prices or cutting costs; improve **liquidity** by reducing inventories, collecting debts faster, or borrowing long-term instead of short-term.

Always compare ratios **with the previous year** or **with competitors**, and say what has changed and **why it matters**.

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Users of accounts

User	What they want to know
Owners / shareholders	profit, ROCE, return on their investment
Banks / lenders	**liquidity** and ability to repay a loan
Managers	performance, to plan and compare
Employees and trade unions	profit and **job security**, scope for pay rises
Suppliers	whether they will be **paid** (liquidity)
Government (tax)	profit, for tax
Potential investors	whether it is worth investing

Users **use ratio results to make decisions**, such as **whether to lend to or invest in** the business, or whether to **grant credit**. **Limitations of ratio analysis**: based on **past** data, may be **manipulated**, differences between **industries**, and ignores **non-financial** factors such as quality and staff morale.

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