Finance and accounts

IB DP Business Management Unit 3 Finance and accounts full package

Customers liked it. The cash ran out.

> A business with a product people like can still fail when cash runs out.

- 2017: ofo had millions of yellow bikes and billions of dollars from investors.
- End of 2018: over ten million users queued online for their deposits.
- How a business plans its money, reads its accounts and judges a project.

Capital or revenue expenditure?

Capital expenditure

Buys **non-current assets**: a workshop, a machine, a van.

Needs long-term finance.

Revenue expenditure

Pays day-to-day running: wages, parts, rent, electricity.

Short-term finance can fit.

Where the money comes from

External source	The trade-off
share capital	never repaid - owners lose some control
loan	large sums - interest even in a bad year
overdraft	flexible - expensive, can be ended any time
trade credit	free for 30-60 days - late payment hurts
leasing	no large payment - costs more in total

Financing the second workshop

1. **Workshop, 120,000** Half **retained profit**, half a five-year bank loan.
2. **Monthly parts bill Trade credit** from suppliers.
3. **Eleven days in December** The overdraft, while wages went out before customers paid.

Decision

Long-term needs, long-term finance; short gaps, short-term finance.

Costs and revenue

Cost	**At the repair business**
fixed	rent, salaries, insurance
variable	car parts, paint, machine energy
semi-variable	a phone contract: monthly charge plus per call
direct	the parts used in one repair
indirect (**overhead**)	the manager's salary, shared by all repairs

The income statement

Income statement	**$**
sales revenue	600,000
cost of sales	(360,000)
gross profit	240,000
expenses	(150,000)
profit before interest and tax	90,000
profit after interest and tax	60,000
retained profit, after dividends	40,000

The statement of financial position

On 31 December	**$**
non-current assets	320,000
current assets	80,000
current liabilities	(40,000)
working capital	40,000
non-current liabilities	(160,000)
net assets	200,000
equity	200,000

Profitability ratios

1. **Gross profit margin** 240,000 / 600,000 x 100 = 40%.
2. **Profit margin** 90,000 / 600,000 x 100 = 15%.
3. **ROCE Capital employed** 160,000 + 200,000 = 360,000; 90,000 / 360,000 x 100 = 25%.

Decision

ROCE of 25% is far above the 6% loan interest - borrowing to invest has paid off.

Liquidity ratios

1. **Current ratio** 80,000 / 40,000 = 2.0.
2. **Acid test** (80,000 - 30,000) / 40,000 = 1.25.
3. **Improve** Sell old stock, collect debts faster, swap an overdraft for a loan.

Decision

Both are healthy - but far above the range means money sitting idle.

Profit is not cash

> A profitable business can fail without cash; a business with cash can survive a loss.

- A repair finished on 28 December is December revenue; if paid in February, the cash arrives then.
- Cash is held for bills, a safety reserve and opportunities.

The forecast that saw April coming

> Seen in January, the April shortfall leaves three months to arrange an overdraft.

- Net cash flow = cash in - cash out; closing = opening + net.
- April: insurance and a big parts order together - closing balance -5,000.

Three ways to fix a cash problem

Approach	Examples	Drawback
reduce cash out	delay equipment; lease; longer supplier credit	old kit may break
improve cash in	faster payment; cash discounts; sell old stock	discounts cut profit
find more finance	overdraft; short-term loan; sell an asset	interest costs

Payback and ARR

1. **Payback** 3 x 40,000 = 120,000: paid back in 3 years.
2. **ARR** (160,000 - 120,000) / 4 = 10,000 a year; 10,000 / 120,000 x 100 = 8.3%.
3. **Compare** 8.3% beats the 6% loan interest.

Check yourself

Your turn

Without notes, for the repair business,

A. Choose finance for a new workshop and for a December gap.
B. Calculate the profit margin and the acid test ratio.
C. Explain how a profitable business can run out of cash.
D. Find the payback and the ARR for the third workshop.