

Financial Information & Decisions

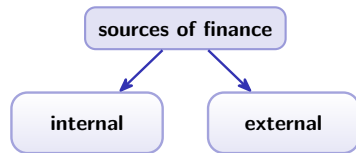
IGCSE Business Studies ■ Topic 5

IGCSE Business Studies



What we will cover

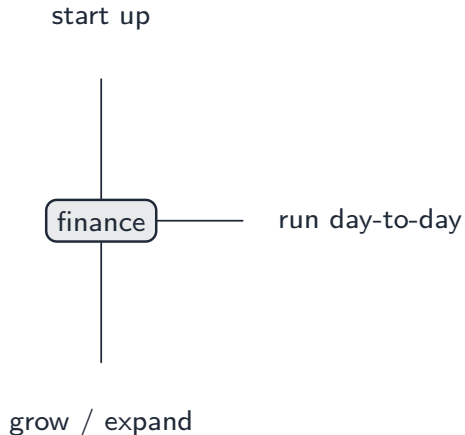
- 1 Why finance is needed
- 2 Sources of finance
- 3 Cash flow
- 4 The income statement
- 5 The balance sheet
- 6 Ratios



sources of finance

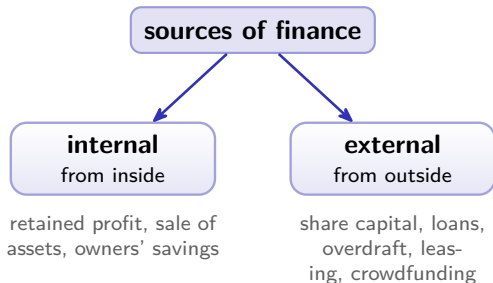


Why finance is needed



- start up – **start-up capital** to buy equipment and stock before it earns anything,
- grow – money for **expansion**, such as new shops or machines,
- run day to day – **working capital** to pay wages and suppliers while waiting for customers to pay,
- survive a **cash-flow** problem, when more money is going out than is coming in.

Sources of finance



Banks are a key external source of business finance, through loans and overdrafts.

The external sources of finance

hire purchase

buy now and pay in **monthly parts**; the asset is owned only at the end

microfinance

small loans for **tiny businesses in poorer areas**, where banks will not lend

crowdfunding

many people each give a small amount, usually online

debentures

long-term loans paying fixed interest, repaid on a set date

grants

money from government that does **not have to be repaid**, usually with conditions

share issue

raises large sums and **dilutes ownership** – available only to a company

To overcome a cash-flow problem a business can arrange an **overdraft**, **delay paying suppliers**, or ask customers to **pay sooner** – all short-term, and all with a cost.

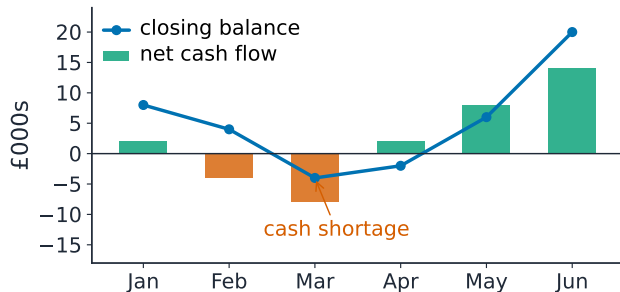
Choosing a source

The best source depends on how much money is needed and for how long, the cost (interest and fees), the size and legal type of the business (only companies can sell shares).

Cash flow

- start up – **start-up capital** to buy equipment and stock before it earns anything,
- grow – money for **expansion** , such as new shops or machines,
- run day to day – **working capital** to pay wages and suppliers while waiting for customers to pay,
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Cash flow, in detail

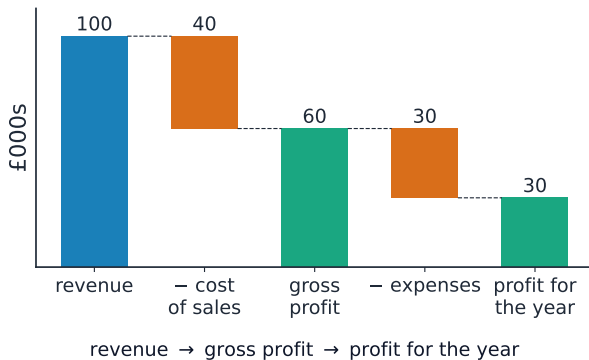


closing = opening + net · negative = cash shortage

A cash-flow forecast tracks the closing balance each month, warning of a shortage early



The income statement

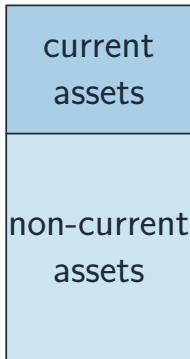


An **income statement** runs from **revenue** down to profit.

- revenue – cost of sales = **gross profit**
- – expenses = **net profit**

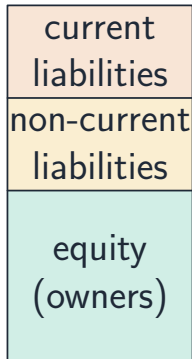
The balance sheet

what it owns



=

funded by



The **statement of financial position** balances:

$$\text{assets} = \text{liabilities} + \text{equity}$$

It shows what the business **owns** & **owes** .

Ratios

profitability

gross & net **profit margin** :
profit as a % of revenue

liquidity

current ratio = current
assets / current liabilities

The ratios, and who reads the accounts

gross profit margin

gross profit as a percentage of revenue – how much each sale contributes before overheads

net profit margin

the same after all costs – what is actually kept

ROCE

profit as a percentage of the **capital employed** – the return on the money invested

current ratio

current assets $\div$ current liabilities – can the firm pay its short-term debts?

the acid test

the same with inventory removed, since stock may not sell quickly

cost of sales

the cost of making or buying the goods that were **sold**

Internal users (owners, managers) read the accounts to control and to plan; **external** users (banks, suppliers, government, investors) to decide whether to lend, supply or invest.

Reading a statement of financial position

Non-current assets

Non-current assets are kept over a year – property, machinery, vehicles.

Non-current liabilities

Non-current liabilities are owed beyond a year – a mortgage, a long-term loan.

Owners' equity

Owners' equity is what is left for the owners: assets minus liabilities.

Acid test ratio

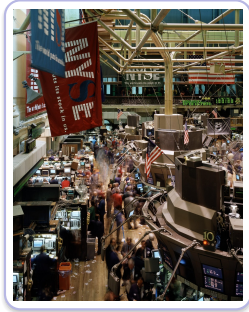
The **acid test ratio** is current assets *less inventory*, over current liabilities – liquidity without assuming the stock can be sold.

ROCE

Return on capital employed : **profit for the year** over capital employed, as a percentage.

Different **stakeholders** read different ratios: a supplier looks at liquidity, an owner at profitability, a lender at gearing.

Who uses account analysis



Markets and accounts: ratios from the income statement and balance sheet show if a firm is healthy

Why businesses need finance



Banks are a key external source of business finance, through loans and overdrafts.

Cash is not the same as profit

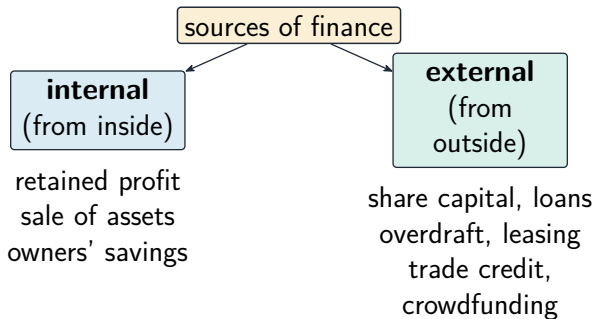
a firm can be profitable but still run out of cash

profit (on paper)
revenue — costs
= positive

cash (in the bank)
low — customers
haven't paid yet

A credit sale earns profit on paper now - the cash arrives much later

Sources of finance, continued



Sources of finance come from inside the business (internal) or outside it (external)

Statement of financial position



A stock exchange: public limited companies raise finance by selling shares to investors.

Working capital

current assets

cash, or soon becomes cash

cash
inventory
owed by customers

current liabilities

debts due within a year

owed to suppliers
overdraft

—

=

working capital

money for
day-to-day
running

Working capital: current assets minus current liabilities

Exam tips

- **Cash is not profit:** a profitable business can still run out of cash if customers pay late. Watch the closing balance on a cash-flow forecast.
- Separate **internal** sources (retained profit, sale of assets, owners' savings) from **external** ones (bank loan, overdraft, shares, leasing, trade credit).
- Key formulas: net cash flow = inflows – outflows; closing balance = opening balance + net cash flow; working capital = current assets – current liabilities.
- Profitability ratios (gross margin, profit margin, ROCE) – higher is better. Liquidity: the current ratio (healthy $\approx 1.5\text{--}2$) and the stricter acid test (which leaves out inventory).
- Only limited **companies** can raise money by issuing **shares**; a sole trader or partnership cannot.



Worked example – cash flow

A shop expects £12,000 in and £9,000 out next month, and starts with £2,000 in the bank.

- Net cash flow = inflows – outflows
 $= 12,000 - 9,000 = \text{£}3,000$
- Closing balance = opening balance + net cash flow
- $= 2,000 + 3,000 = \text{£}5,000$
- This month's closing balance is **next month's opening balance**.

Cash flow is **not** profit: a profitable firm can still run out of cash if customers pay late. Most business failures are **cash** failures.

Topic 5 – key takeaways

1

Sources

internal (retained profit) vs
external (loans)

2

Cash

cash $\neq$ profit; forecast inflows &
outflows

3

Income

revenue to gross profit to net
profit

4

Balance

assets = liabilities + equity

Check yourself

- 1 Is retained profit internal or external?
- 2 Can a profitable business run out of cash?
- 3 Revenue minus cost of sales is what?
- 4 What must a balance sheet always do?



Answers 1. internal 2. yes 3. gross profit 4. balance (assets = liabilities + equity)