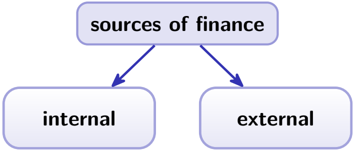
Financial Information & Decisions

IGCSE Business Studies ▪ Topic 5

IGCSE Business Studies

What we will cover

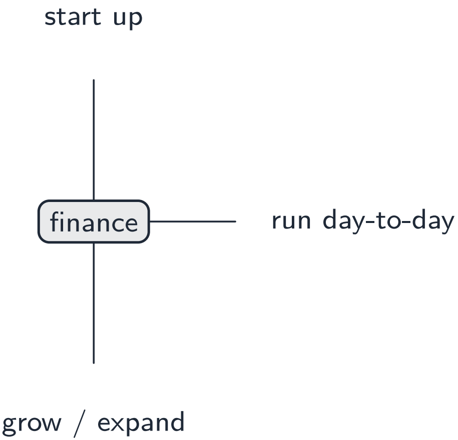
1. Why finance is needed
2. Sources of finance
3. Cash flow
4. The income statement
5. The balance sheet
6. Ratios



sources of finance

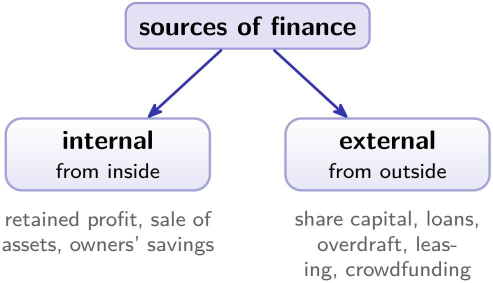
1 Finance

Why finance is needed



- start up – **start-up capital** 启动资金 to buy equipment and stock before it earns anything,
- grow – money for **expansion** 扩张, such as new shops or machines,
- run day to day – **working capital** 营运资金 to pay wages and suppliers while waiting for customers to pay,
- survive a **cash-flow** 现金流 problem, when more money is

Sources of finance



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

The external sources of finance

hire purchase 分期付款	buy now and pay in monthly parts; the asset is owned only at the end
microfinance 小额信贷	small loans for tiny businesses in poorer areas, where banks will not lend
crowdfunding 众筹	many people each give a small amount, usually online
debentures 债券	long-term loans paying fixed interest, repaid on a set date
grants 补助金	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.

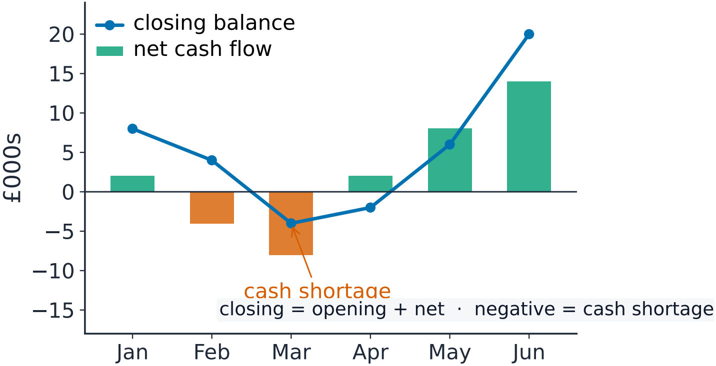
Choosing a source

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

Cash flow, in detail

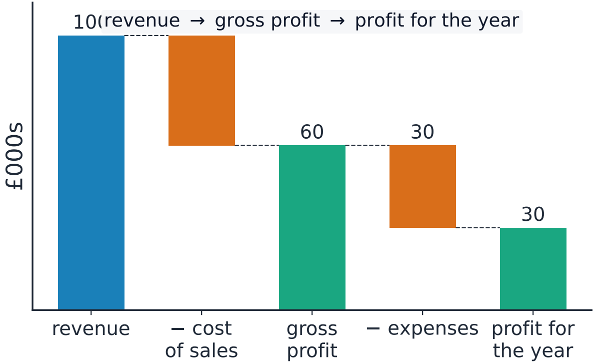


A cash-flow forecast tracks the closing balance each month, warning of a shortage early

2

Accounts

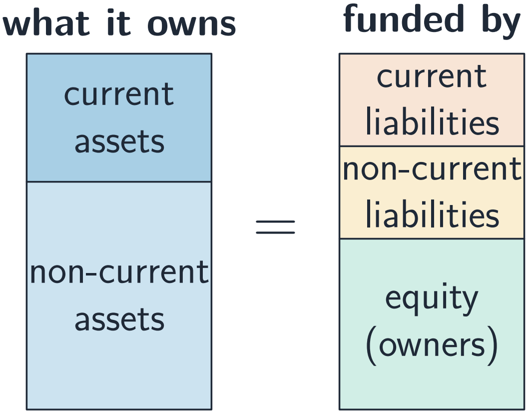
The income statement



An **income statement** 损益表 runs from **revenue** 收入 down to profit.

- revenue − cost of sales = **gross profit** 毛利
- − expenses = **net profit** 净利

The balance sheet



The **statement of financial position** 资产负债表 balances:

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

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

Ratios

profitability 盈利能力

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

liquidity 流动性

current ratio 流动比率 = current assets / current liabilities

The ratios, and who reads the accounts

gross profit margin 毛利率	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 资本回报率	profit as a percentage of the **capital employed** 资本使用额 – the return on the money invested
current ratio	current assets ÷ current liabilities – can the firm pay its short-term debts?
the acid test 速动比率	the same with inventory removed, since stock may not sell quickly
cost of sales 销售成本	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** 非流动资产 are kept over a year – property, machinery, vehicles.
Non-current liabilities	**Non-current liabilities** 非流动负债 are owed beyond a year – a mortgage, a long-term loan.
Owners' equity	**Owners' equity** 所有者权益 is what is left for the owners: assets minus liabilities.
Acid test ratio	The **acid test ratio** 速动比率 is current assets *less inventory*, over current liabilities – liquidity without assuming the stock can be sold.
ROCE	**Return on capital employed** 资本回报率: **profit for the year** 年度利润 over capital employed, as a percentage.

Different **stakeholders** 利益相关者 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

sell goods for $1 000 **on credit** - the customer will pay in month 3

month 1
sale made:
profit recorded ✓

→

month 2
wages and
rent due,
but no cash
in yet!

→

month 3
customer pays:
cash finally arrives

profitable on paper, but out of cash - this can close a business

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

Sources of finance, continued

sources of finance

internal
(from inside)

retained profit
sale of assets
owners' savings

external
(from outside)

share capital, loans
overdraft, leasing
trade credit,
crowdfunding

> 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 1.5–2) and the stricter acid test (which leaves out inventory).
- Only limited **companies** can raise money by issuing **shares**; a sole trader or partnership cannot.

3 Recap

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 $= 12{,}000 - 9{,}000 = £3{,}000$
- Closing balance = opening balance + net cash flow
- $= 2{,}000 + 3{,}000 = £5{,}000$
- 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)