International
Preparation Course in Business

Business Finance module
Summary session
L01, L02 and L03

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Aims and objectives for today’s session

- Summarise Finance module on IPC
- Key questions to consider for LO1, L02 and LO3
- Answer any questions on the module
- Look at some lesson plans if available

Course handbook

Describe the purpose of accounting for an organisation. Describe the different capital and revenue items of expenditure and income in an organisation	Explain the difference between capital and revenue items of expenditure and income	Evaluate the importance of a finance department in a business.

1. Understand the purpose of accounting and the categorisation of business income and expenditure

- Purpose: record transactions; monitor activity; control; management of the business (planning, monitoring, controlling); measurement of financial performance (gross profit, net profit, value owed to and by the business)
- Capital income: sole traders; partners; shares; loans; mortgages Revenue income: sales (cash and credit transactions); rent received; commission received
- Capital expenditure: fixed assets (land and buildings; office equipment; machinery; furniture and fittings; motor vehicles); intangibles eg goodwill, patents, trademarks
- Revenue expenditure: premises costs eg rent, rates, heating and lighting, insurance; administrative costs eg telephone charges, postage, printing, stationery; staff costs eg salaries, wages, training, insurance, pensions; selling and distribution costs eg sales staff salaries, carriage on sales, marketing; finance costs eg bank charges, loan and mortgage interest; purchase of stock (cash and credit transactions)

LO1 - two parts

1. Accounting purposes

2. Categorisation of income and expenditure in accounting

LO1 - 1 Accounting purposes

What are the main **purposes of accounting**?

Who might be interested in the accounting information? **Why**?

Why do businesses have to **follow strict accounting guidelines**? Why is it important?

What would be the **consequences** for the business of ignoring accounting information and guidelines?

Accounting

Accounting involves making a record of the business's financial transactions, then preparing a set of accounts from this information which may be used to evaluate the business's performance. You will need to revise the five main purposes of accounting.

Accounting purposes

1 Recording transactions

Accountants record all money coming into and going out of the business. This enables them to keep track of payments received and ensure bills and taxes are paid on time.

2 Management of business

The manager of a business is responsible for:

- planning – to foresee likely financial commitments
- monitoring – to check performance and spending
- controlling – to ensure sufficient funds are available to cover outgoings.

3 Compliance

All businesses have a responsibility to comply with financial reporting requirements in accordance with laws and regulations.

Internal accounting controls help to combat fraud.

4 Measuring performance

Accountants measure how well the business is performing financially through its:

- gross and net profit
- sales revenue
- efficiency in collecting money owed to the business
- expenditure
- costs.

5 Control

Accounting also tracks:

- trade receivables – debts that are generated by the sale of products or services between businesses (money owed to the business)
- trade payables – debts that have been created as a result of purchasing products or services from other businesses

LO1 - 2 Categorisation of income and expenditure in accounting

Categorisation of income and expenditure in accounting

- **Capital income**
- **Capital expenditure**
- **Revenue income**
- **Revenue expenditure**

Students need to know the difference between the categories and be able to place examples into the categories.

Link this to the previous topic by explaining that ‘accounting’ records different types of business transactions, the above are the categories of transaction that will happen in business during the financial year.

Income

Income is money received by the business. On this page, you will revise the differences between capital income and revenue income.

Capital income

This is money used to set up a business. It is a long-term investment.
Examples of capital income include:

Loan – money lent to a business by an investor such as a bank. The business will pay back the loan with interest, usually in monthly instalments over a few years.

Mortgage – loan usually used to buy property, such as a business premises. The mortgage will be secured against the property purchased. The business will pay back the mortgage with interest usually over 25 years.

Capital income

Debentures – a type of bond issued by large companies to raise money. Investors receive interest on their loan which is repaid in full by the company on an agreed date.

Shares – issued by the company to shareholders who own the business. As investors in the business, shareholders may receive a dividend.

Owner's capital – the owner invests their personal savings in the business. The owner may be a sole trader or a partnership.

Revenue income

This is income received by the business on sales of its goods or services.
Examples of revenue income include:

Revenue income

Cash sales – through over the counter transactions

Credit sales – through sales using a method of credit

Rent received – when a business rents out a property it owns

Discount received – when a business pays a reduced price for goods or services

Interest received – money earned on savings or lending

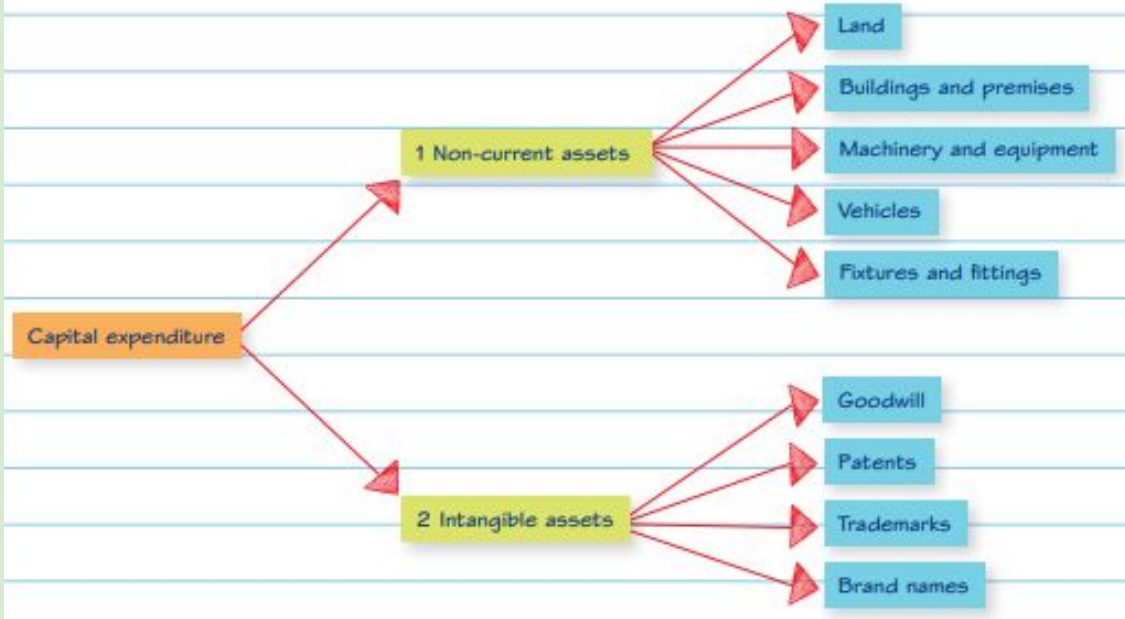
Commission received – when a business acts as an agent for another business and receives a percentage of every sale

Capital expenditure

Expenditure refers to items bought by the business. There are two types of expenditure: capital and revenue. On this page, you will revise capital expenditure.

Capital expenditure

These are assets – capital items – that the business plans to use over a long period of time. There are two types of assets: non-current (tangible) and intangible.



Revenue expenditure

On this page, you will revise revenue expenditure – the day-to-day costs incurred in running a business.

Links Revise revenue income on page 60.

Revenue expenditure

Rates – business tax on non-domestic property used to fund local council services

Heating and lighting – payment for services such as gas and electricity

Rent – only paid by businesses that do not own their own premises

Water – payment for supply of water to premises

Inventory – raw materials, finished products, supplies required to run a service business

Insurance – businesses are legally required to take out buildings, contents, public liability and employer's liability insurance

Discount allowed – customers receive money off goods either as an incentive to purchase or buying in bulk

Administration – paperwork required to run a business

Interest paid – on mortgages and loans

Telephone – administrative cost

Postage – administrative cost

Bank charges – bank account fees payable on every transaction

Stationery and printing – administrative cost

Wages – hourly rate paid to an employee

Salaries – annual sum of money, divided into equal monthly payments, paid to an employee

Straight-line depreciation

Reducing-balance depreciation

Marketing – costs related to promoting and selling goods and services

Important

Students need to understand that **different types of income and expenditure** have different effects on the business finances.

For example:

Capital expenditure - buying a new van

- This will affect the ‘statement of financial position’ (swapping ‘money/cash’ for a ‘non-current asset’) but not the profit of the business until this item gets depreciated over time.

Revenue expenditure - using electricity

- This will reduce the profit in the ‘statement of comprehensive income’ in the year that it is used

LO2 - Cash flow forecasting - key questions

What is **cash flow** in business?

What is a **cash flow forecas**t?

What is the typical **layout** of a cash flow forecast? (students need to be able to complete one with given numbers)

What are typical r**eason f**or cash flow problems in business?

What are typical **solutions** to cash flow problems?

What are the **benefits** of creating a cash flow forecast?

What are the **limitations** of cash flow forecasting?

Follow with some useful definitions

- Cash flow
- Cash flow forecast
- Cash inflows
- Cash outflows
- Opening balance
- Net cash flow (also known as ‘cash surplus’, inflows minus outflows)
- Closing balance

Cash flow forecasts

Cash flow forecasts are used by businesses to identify potential problems with cash flow. This will enable them to plan, monitor and control spending more effectively.

Format of forecast

Opening bank balance
Itemised receipts or cash inflows
Total of receipts added to opening balance
Itemised list of payments
Total of payments or cash outflows – this is then deducted from the total of the receipts
Closing balance – this is calculated by adding the net cash flow and opening balance together. This becomes the opening balance for the following month

Entering data

It pays to be systematic when constructing a cash flow forecast, as it is important for the figures to be correct.

Consider:

- ✓ Are the figures realistic?
- ✓ What do the figures actually show?

How could potential cash flow problems be resolved?

	January	February	March
Opening Balance			
Receipts from sales			
Receipts from rent			
Total receipts (inflows)			
Total cash available			
Premises			
Energy			
Wages			
Suppliers			
Total payments (outflows)			
Net cash-flow (inflows - outflows)			
Closing balance			

Structure of a cash flow forecast

- **Opening balance** =
- Cash available to the business at the **beginning** of the month
- **Total inflows** =
- Sum of all cash coming into the business during that month
- **Total cash available** =
- Opening balance + total cash in
- **Total outflows** =
- Sum of all cash going out of the business during that month
- **Net cash flow (or 'cash surplus')** =
- Total inflow minus total outflows (can be positive or negative)
- **Closing balance** =
- Cash available to the business at the **end** of the month
- Opening balance + net cash flow

The flow of cash into and out of a business has to be carefully managed. Having too little cash means that suppliers, and even employees, may not be paid on time.

Profit and cash

Businesses selling lots of products and services may have major cash flow problems. If the business is selling products and services and recording them as being sold they may be short of cash if they have sold them on credit as they will not have yet received the money. They will need to replace the inventory but as they have not been paid for items they have already sold, they may not have funds to do this.

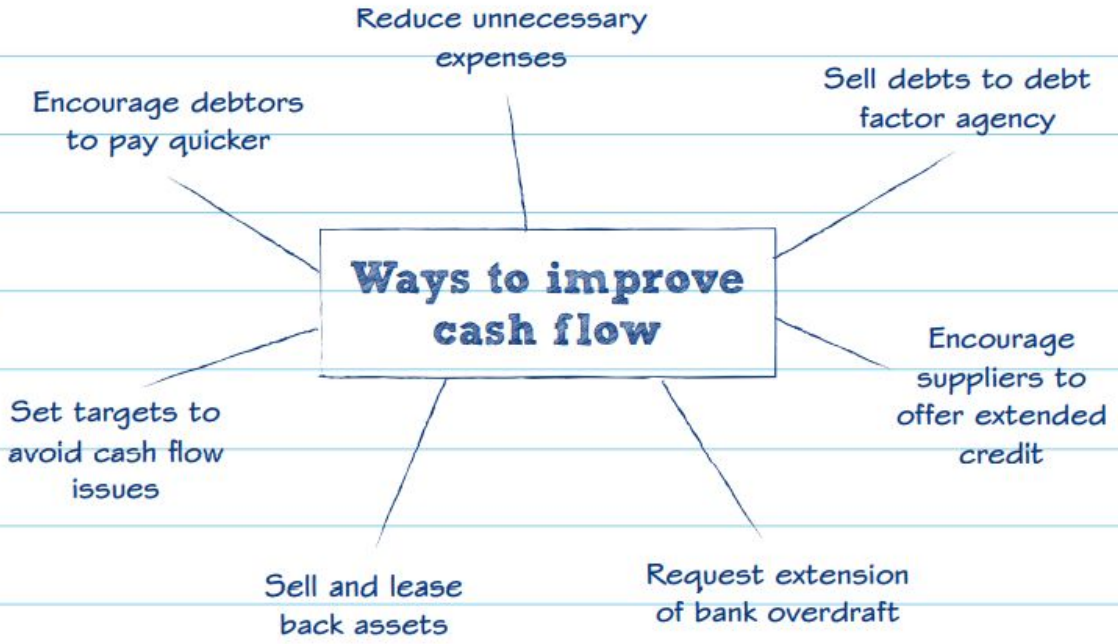
Students need to understand the need for sufficient ‘cash’ in the business.

- Generating revenue which will increase profit does not always mean an immediate increase in cash, e.g. if a customer payment is delayed.
- A business can benefit from delaying a supplier payment by agreeing a ‘trade credit’.

Benefits and limitations

Cash flow forecasts should help the business predict when they might have cash flow problems. If the business has predicted and planned for its financial needs, then banks may extend overdrafts or offer loans.

Cash flows fail to consider that a business can delay payments to increase their net cash inflows and that it can buy using a leasing arrangement to avoid using cash.



Summary/conclusion

- Students need to
- know the **terminology** linked to cash flow forecasting.
- understand the **layout** of a cash flow forecast.
- be able to **complete** a 12-months cash flow forecast using numbers provided to them.
- be able to describe and **evaluate** typical **cash flow problems** (what are they? How serious can they be? What would be the consequences for the business if not addressed)
- be able to **suggest and evaluate solutions** to cash flow problems.
- Evaluate **benefits and limitations** of cash flow forecasting.

LO3 - End of year statements - key questions

Part 1

What are *'end of year statements'*?

What is a '***statement of comprehensive income'***? (content, layout, function)

What is a '***statement of financial position***'? (content, layout, function)

Part 2

What are ***financial ratios***? What is *financial ratio analysis*?

Ratios to be covered:

Profitability (GPM, (Mark-up), NPM, ROCE), Liquidity (Current ratio, Liquid Capital Ratio)

What do the above ratios tell the business about their financial state, i.e how do they help analysing the end of year financial statements?

Statement of comprehensive income

At the end of the financial year, a business produces a statement of comprehensive income – which includes a statement of profit and loss – that records sales revenue and expenses and shows how much profit or loss the business has made. On this page, you will revise the various elements of an income statement and how to calculate gross profit and profit or loss.

Purpose and use

The statement sets out the business's revenue and expenses. It shows whether a business's turnover has grown or shrunk and where costs have been incurred. Of particular importance is the amount of net profit and how the business has used it.

Calculations

The business's income from sales minus its direct costs is equal to its gross profit. From this gross profit figure other costs are deducted, such as rent and wages. This produces the operating or trading profit.

To work out the net profit before tax the sales of any assets or profits are added. The business then pays tax on its net profit.

The remaining figure is its profit and the business needs to decide what to do with it.

Layout of ‘statement of comprehensive income’ (also simply called ‘income statement’)

- Example with numbers

Chique T-shirts Statement of comprehensive income for the year ending 30 April 2016		
	£000	£000
Sales		236
Less cost of sales		
Opening stock	51	
Purchases	71	
Closing stock	10	
Cost of goods sold		**112**
Gross profit		**124**
Expenses		
Insurance	10	
Business rates	22	
Administration	15	
Wages	45	
Marketing	10	
Utilities	8	
Depreciation	6	
Total expenses		**116**
Net profit before tax		**8**

Simple layout without numbers, could be used as a puzzle activity

Statement of comprehensive income

SALES

COST OF SALES
opening stock
+ purchases
- closing stock
TOTAL COST OF SALES

GROSS PROFIT (SALES less COST OF SALES)

EXPENSES
rent
utilities
advertising
TOTAL EXPENSES

NET PROFIT (GROSS PROFIT less EXPENSES)

Useful definitions to be introduced for Statement of financial position

- Statement of financial position
- Assets (in accounting)
- Liabilities (in accounting)
- Non-current (fixed) assets
- Current assets
- Current liabilities
- Net current assets (working capital)
- Non-current liabilities
- Capital (in accounting)
- Trade debtors/trade receivables
- Trade creditors/trade payables

Layout of ‘statement of financial position’

- Example with numbers

Chique T-shirts Statement of financial position for the year ending 30 April 2016			
	(Historical) cost	Accumulated depreciation	Net book value
	£000	£000	£000
Non-Current (Fixed) Assets			
Premises	12	0	12
Fixtures and fittings	12	4	8
Machinery	16	6	10
Vehicles	8	3	5
	48	**13**	**35**
Current Assets			
Stock		10	
Trade Receivables (Debtors)		53	
Cash in bank		49	
Cash in hand		14	
Total Current Assets			**126**
Current Liabilities			
Tax owed	29		
Creditors	20		
Total Current Liabilities			**49**
Net Current Assets (Working Capital)			**77**
Non-current Liabilities (long-term)			
Bank loan			1
NET Assets (employed)			**111**
Financed by:			
Opening Capital			110
Add Net profit			8
Less Drawings			7
Capital employed			**111**

Simple layout without numbers, could be used as a puzzle activity

Statement of financial position (balance sheet)

NON CURRENT ASSETS
- Premises and Building
- Machinery
- Vehicles
- Equipment

TOTAL NON-CURRENT ASSETS

CURRENT ASSETS
- Stock
- Debtors
- Bank
- Cash

TOTAL CURRENT ASSETS

CURRENT LIABILITIES
- Creditors
- Overdraft

TOTAL CURRENT LIABILITIES

WORKING CAPITAL (NET CURRENT ASSETS, CA-CL)

LONG-TERM LIABILITIES
- Mortgages
- Loans

TOTAL LONG-TERM LIABILITIES

NET ASSETS EMPLOYED
(Fixed Assets + Net Current Assets – LT Liabilities)

CAPITAL EMPLOYED
- Capital and Reserves
- Net Profit
- Less drawings

TOTAL CAPITAL EMPLOYED

Note:

Net assets employed always have to *balance* **Capital employed**

Net current assets and liabilities

Subtract current liabilities from the current assets. If the figure is positive then it shows that the business has a surplus of working capital to cover its liabilities.

If the figure is negative (in other words, the liabilities are greater than the assets) then the business does not have any working capital and is unlikely to be able to cover its current liabilities.

Non-current liabilities

Non-current liabilities are those that are due after more than a year. A business may have arranged a long-term bank loan, or perhaps it has a mortgage. It will be paying instalments on those borrowings, but the full amount or balance is not due within the next 12 months.

Net assets

Net assets are known as *net worth*. It is the total assets of a business (current plus non-current assets) minus its total liabilities (current liabilities plus its non-current liabilities).

Net assets = (current assets + non-current assets) - (current liabilities + non-current liabilities)

Which can be restated as:

Net assets = total assets - total liabilities

Capital

Capital is either cash or other assets that have been introduced to the business, or removed from the business:

- Opening capital – the value of investment by the owners
- Transfer of profit or loss – the statement of comprehensive income shows the profit or loss of the business
- Drawings – funds that could be either salary or wages taken by the owners
- Closing capital – equal to the opening capital plus or minus any of the above figures

Summary/conclusion

- Students need to
- understand the meaning and layout of the statement of comprehensive income
- understand the meaning and layout of the statement of financial position
- be able to carry out simple calculations relating to the end of year statements

LO3 - End of year statements - key questions

Part 1

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Follow with some useful definitions

- Profitability
- Liquidity
- Financial ratio analysis

Interpretation and analysis – key aspects to consider

- Profitability of the business – measured by its profit margins, mark up and efficiency in using capital
- Liquidity – the business's ability to be able to cover its current liabilities by its current assets

Gross profit and mark-up

Businesses use four profitability ratios to measure how well they are performing. On this page, you will revise gross profit margin and mark-up and how to calculate them.

Gross profit margin

This enables a business to work out the gross profit on goods sold after deducting their cost. Gross profit is measured as a percentage of revenue.

A business can improve its gross profit margin either by increasing sales, or by reducing its costs.

Mark-up

The mark-up is the percentage added to the cost to create the selling price. Gross profit is measured as a percentage of cost of sales.

The larger the mark-up, the greater the gross profit.

Gross profit margin formula

$$\frac{\text{gross profit}}{\text{revenue}} \times 100$$

Mark-up formula

$$\frac{\text{gross profit}}{\text{cost of sales}} \times 100$$

Calculating gross profit margin

A business has a gross profit of £6000 on sales of £10 000. The gross profit margin is:

$$\frac{£6000}{£10\,000} \times 100 = 60\%$$

For every £1 that the business makes in sales 60p is gross profit.

Calculating mark-up

A business has sales revenue of £100 000. It shows a gross profit of £20 000 on those sales. The mark up is:

$$\frac{£20\,000}{(£100\,000 - £20\,000)} \times 100 = 25\%$$

E.g.

Business sells products for £100 in total.

60% GPM means that £60 of the £100 is their gross profit, to be used for covering expenses

E.g.

Cost of Sales (product cost) = £0.80 per unit

Mark-up 25%

Then
Selling price would be £0.80 + £0.20 = £1.00

Profit margin and ROCE

On this page, you will revise two further profitability ratios – net profit margin and return on capital employed – and how to calculate them.

Links See gross profit and mark-up on page 76.

Net profit margin

This ratio measures the profit made by the business after all expenses have been deducted – net profit. For this reason, it is considered to be a more accurate measure of efficiency and performance than gross profit margin ratio. It is measured as a percentage of revenue. If net profit falls, the business may take steps to reduce its expenses.

Return on capital employed (ROCE)

Investors and owners put capital into a business in the hope that this will enable it to make a profit. From this profit, investors expect a return (profit) on their investment. This ratio measures the return on capital as a percentage of the capital employed, and shows how efficiently the business uses the money invested. A high profit from a low investment means the business is performing well.

Net profit margin formula

$$\frac{\text{net profit}}{\text{revenue}} \times 100$$

ROCE formula

$$\frac{\text{net profit before interest and tax}}{\text{capital employed}} \times 100$$

Calculating net profit margin

A business has sales of £90 000, with expenses (rent, rates and wages) of £60 000. The net profit is £90 000 – £60 000 = £30 000. The net profit margin is:

$$\frac{£30\,000}{£90\,000} \times 100 = 33.33\%$$

For every £1 of sales, 33p is net profit.

Calculating ROCE

Two business owners invest £120 000 into a new business. In the first year, the business shows a profit of £440 000. ROCE is:

$$\frac{£440\,000}{£120\,000} \times 100 = 366\%$$

For every £1 of capital invested, the owners received £3.66.

Liquidity

Liquidity ratios allow you to measure the ability of a business to be able to pay its short-term debts. You need to revise current and the liquid capital ratios, and how to calculate them.

Current ratio

This is also known as the working capital ratio. It measures a business's assets compared to its liabilities and shows whether a business is being managed properly.

Ideally a business should have £1.50 of assets for every £1 of debt. So the ideal ratio is 1.5:1. If it has less than 1:1 it will struggle to pay its debts. It will not have sufficient current assets to cover current liabilities.

Liquid capital ratio

This is sometimes known as the liquidity ratio or the acid test ratio. It removes inventory from the calculation as this may be difficult to quickly turn into cash to pay a debt.

The ideal ratio is 1:1. If a business has less than this it will have problems paying off its current liabilities.

Current ratio formula

$$\frac{\text{current assets}}{\text{current liabilities}}$$

Liquid capital ratio formula

$$\frac{(\text{current assets} - \text{inventory})}{\text{current liabilities}}$$

Calculating current ratio

A business has current assets amounting to £46 000. Its current liabilities are £39 000. The current ratio is:

$$\frac{£46\ 000}{£39\ 000} = 1.18:1$$

The business has just enough current assets to cover its debts.

Calculating liquid capital ratio

The same business has £3800 tied up in inventory. The calculation for the liquid capital ratio is:

$$\frac{(£46\ 000 - £3800)}{£39\ 000} = 1.08:1$$

The business has just enough to cover its short-term debt, just over 1:1.

So this ratio would be below the ideal of 1.5:1, too low, may indicate cash-flow problems if stock not sold.

So this ratio is slightly above the ideal, so looks better for the business, but they would be under pressure of selling their stock to cover current liabilities.

Summary/conclusion

- Students need to be able to

- Explain what **financial ratio analysis** is in business
- Understand what **profitability and liquidity** mean
- Know the formulas, be able to **calculate and evaluate** the following ratios: **GPM, (Mark-up), NPM, ROCE, CR, LCR**

Exam questions

- There will be MCQs, including calculations
- There will be a cashflow forecast for the students to draw up - calculator needed.
- There will be incomplete end of year statements with numbers and/or words missing (fill the gaps)
- There will be higher level questions on each LO, ‘assess and evaluate’.

THANK YOU

ANY QUESTIONS?

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