

Financial Information and Decisions

Main Unit Topics:

1) Finance Categories

2) Sources of Finance

- I. Internal
- II. External
- III. Short-term
- IV. Long-term

3) Cash Flows

- I. Format
- II. Cash Flow Forecasting

4) Financial Statements

- I. Balance Sheet + Format
Working Capital
- II. Income Statement

5) Ratio Analysis

- I. Profitability Ratios
- II. Liquidity Ratios

The department handling finance is the Finance Department.

There can be financial planners, financial analysts, accounts executives, and assistant executives in this department, it mainly depends on how large the business is.

It is VERY important to keep track of financial information in a business.

Final Accounts

The Finance Department prepares something known as “Final Accounts”.

Final Accounts can only be prepared if proper finance records are kept throughout the year.

These are paid at the end of the year, and these **represent the important data recorded throughout the year.**

Financial Periods

A company could start its financial period at the end of June, and end on the 30th of May. Not every business has a similar financial year.

Fiscal year refers to one year's worth of accounting activity and can be any 12-month period throughout the year

Financial Reports

The department has the responsibility to **provide financial reports to managers** (or any other department).

They **set budgets** for certain departments and things within a business.

They are the ones making any important financial decisions.

3 Main Finance Categories:

1. When **starting** a business.
2. When **expanding** a business.
3. When increasing **working capital (day to day expenses)**.

Try thinking of anything else, and it'll fall into these three categories.

2 Types of Expenditure:

Capital Expenditure

The money a business spends on **buying fixed assets**.

Fixed asset (More than 1 year) e.g property, machinery

Non-fixed asset (Less than a year) e.g inventory, capital, trade receivables.

Trade receivables/debtors is the money that you have yet to receive from customers after the credit period ends.

Revenue Expenditure

The money that a business spends on day to day expenses/non-fixed assets

E.g. wages, salaries, rent, utilities, loans, etc.

Sources of Finance

2 Types of Finance

Internal Finance

Money that arises from within the business.

Types of Internal Finance

Sale of an Existing Asset

In addition, another way of internal finance is the sale of an existing asset. E.g. if there's any **machine or asset** which is not being utilized and so it is **sold** for finance.

Advantage:

- 1) Great source of capital which **doesn't increase your debt**.
- 2) It **sheds useless resources** lying around.

Disadvantage:

- 1) A startup company will not be able to do this.
- 2) The target capital a business hopes to achieve from a sale is not finalized until the asset is sold.

Owners Savings

Advantages:

- 1) It's right there, you can **use it immediately**.
- 2) It **helps with startups**.

Disadvantages:

- 1) **More risk** if you put more savings in the business.
- 2) May be **limited**

Retained profit

The **profit left after all expenses**

External Finance

Finance generated from outside the business.

Types of External Finance

Bank Loan

A loan you take from the bank, but you have to **pay interest** upon paying it back. You can also **pay back in installments. It can be for different periods of time.**

The bank will ask for collateral when giving a loan. They will **keep any one of your assets** so that in case you can't pay the loan or you disappear the **bank can sell the asset**. It is the bank's **security**.

Advantages:

- 1) It's **quick and efficient**.
- 2) **Good for startup business** with no current finance

Disadvantages:

- 1) The **business must be credible** to receive a larger loan.
- 2) You will also have to pay **interest**.

Share Issues

You **sell the company's shares** to the public in exchange for capital.

Advantages:

- 1) It's a **permanent source of capital**, you don't have to give it back.

Disadvantages:

- 1) You **can't sell it all** otherwise you lose ownership.

Debenture(only happens with private and public limited companies)

debenture: very long term and big loan. (zesty)

Only **for *pvt or ltd***. An individual **buys a debenture from a company for a large sum of money**, which the **company has to give back** over a long period of time with *interest*.

Advantages:

- 1) Very **long term source of finance**.
- 2) **Quick** and easy.

Disadvantages:

- 1) Can only be done by large companies.
- 2) Have to give interest.

Debt Factoring

Debt arises when one party (**the debtor**) **borrow money from another party (the creditor)** and is obligated to repay it.

If the **debtor fails to repay** the owed amount, the creditor may seek assistance from a **specialist agency**.

This **agency compensates the creditor** for the outstanding debt (minus a **commission** fee) and then takes responsibility for recovering the funds directly from the debtor.

Lengths of Finance

Short term Finance

Types of Short Term Finance

Overdraft

There is a thing in short term finance called overdraft which is managed by the bank. This is when you **take more money from your account than you actually have**.

There is an **overdraft limit decided by the bank**, which is usually less.

You have to pay **interest** on how much money you overdrew.

Advantage:

- 1) You get the **money immediately**

Disadvantage:

- 1) You have to pay **interest**
- 2) There is an **overdraft limit**

Trade Credit

You take money or any product from someone and you pay back later.

Debt Factoring

Long Term Finance

Types of Long Term Finance

Bank Loans

Long Term Loan

Debenture

Share Issues

Hire Purchase (installments, you buy something from installments, you pay a mark up after paying all the monthly payments)

To **buy stuff on installments.**

Markup is added, which is when the seller increases the price by a certain percentage in exchange for the installment benefit.

Advantage

- 1) You get the **product without paying the full price** immediately.

Disadvantage

- 1) You have to pay **markup**.

Leasing (renting)

When you **don't have enough money to buy something**, you lease it **from some third party without paying**.

You **don't own it but you can use it**. You have to give **monthly lease payments** and when you have paid the full amount you can choose whether you want to buy the asset or not.

Sale and Lease Back

When you own an asset, then sell it, then lease it back immediately.

The advantage is that you can sell your asset and lease it back immediately, which allows you to get money and also keep the asset.

Variable Interest

When you lease something from the bank, you have to pay interest every month on the payment. This interest changes every year

Deciding Finance Type

When deciding what type of finance you need, you must think about what the purpose and time period of the finance is.

When buying a fixed asset, you will go for long term finance.

Things to consider:

- 1) Buying Fixed Asset → Long term
- 2) Buying Non-fixed Asset (an asset which you don't own for more than a year) → Short Term
- 3) Legal form
- 4) Business Size (can't do debenture if small)
- 5) Control (won't issue many shares if less shares left)
- 6) Risk Factors (won't take more bank loans if you already have big debt)

Cash Flows

Cash is a non-fixed asset. We also call it a **liquid asset**, because it is **readily available** and we can quickly spend it.

Cash flow (its a chart which tells us the money coming in and out of the business over a period of term eg 1 month) consists of:

- 1) Cash Inflow
- 2) Cash Outflow

Over a certain period of time

Cash inflow → The **money coming in** the business

Cash outflow → The **money going out** of the business

Cash Flow Cycle

- 1) You need cash to pay for rent, materials, wages etc.
- 2) Goods produced
- 3) Goods sold
- 4) Cash received

Cash inflow — Cash outflow = Net Cash Flow

100k — 80k = 20k

Net cash flow is NOT PROFIT. Cash flows are usually made on a **monthly basis**

How to calculate gross profit

Sale Revenue — Cost of goods sold = Gross Profit

Cash flow → Real time tracking of liquid cash

Profit → How much money is left over after you've paid all your expenses.

Profitable businesses can still run out of cash. Called Insolvency.

Causes:

- 1) Giving customers a **too long credit period**
- 2) **Purchasing too many fixed assets** at once – big stream of cash outflow
- 3) **Expanding too quickly**, can't manage, high working capital etc.

Cash Flow Forecasting

The **estimation of future cash flows**. Done on a **monthly basis**. This **helps with managing costs**.

Banks may also ask for cash flow forecasting so that they know if you will be able to pay it back.

Opening Balance

How much cash you have in the beginning of the month

Closing Balance

How much cash you have at the end of the month.

Opening Balance + Net Cash flow = Closing Balance

Figures in brackets are negative.

Statement of Cash Flows

The **actual cash inflow and outflow** as well as the net cash flow that happened, not what was forecasted.

After seeing this, businesses check what problems they have, which is called **short term cash flow problem** (out>in). It can also be because

Businesses compare their cash flow forecast and their statement to see how much they were off.

Financial Statements

Usually made for 1 year, but can be made before that time as well e.g quarterly or half yearly.

Must be made public every year.

2 Types

- 1) Balance Sheet Proper name → Statement of financial position
- 2) Profit and Loss Proper name → Statement of comprehensive income and Income statement

Balance Sheet

The purpose is to **list** a company's **assets and liabilities**.

Format

1st Heading: Assets

Subheadings:

- 1) Current Assets (Non-fixed Assets)
- 2) Noncurrent Assets (Fixed assets)

Another Heading: Total Assets → Add up Current and Noncurrent

2nd Heading: Liabilities (Money you owe)

Subheadings:

- 1) Current/Short-term Liabilities (must pay within a year). We call the money we owe to creditors **account payables**
- 2) Noncurrent/Long-term Liabilities Asset (Can pay after year)

Last Heading: Total Liabilities → Add up Current and Noncurrent Liabilities

3rd Heading: Shareholders' Equity

Subheading:

- 1) Share capital → Capital received when issuing shares
- 2) Retained Earnings/Profit → What the business keeps

Last Heading → Add up

Intangible Assets → Assets that don't exist

- 1) Trademark
- 2) Patent

3) Goodwill

Working Capital

It is the Lifeblood of the business, it is the capital used in **day to day expenses**.

Current assets - Current liabilities = W.C

W.C can be in the form of cash.

The value of a firm's debtors is related to the volume of production and sales. To achieve higher sales, there may be a need to offer additional credit facilities.

Meaning:

If we allow customers to buy on trade credit (buy now, pay later) more people will buy, so if we want higher sales then we should offer more credit facilities (like giving them the option to pay later or on hire purchase).

Buffer Stock: Extra stock produced just in case there is a **big order**.

Capital Employed: The money you and 3rd parties have put into the business.

Shareholders Equity + Non-current Liabilities = Capital Employed

Income Statement

Also called “**Statement of Comprehensive Income**” or “**Profit and Loss Statement**”. SOCI is more modern.

It talks about **profit and loss**. The money we make from selling the product is profit.

It also shows **interest**.

Monetary Formulas

Sales Revenue

The total amount of **units sold x price of unit**

Cost of Goods sold

The cost of making the goods. Includes raw materials, labor etc.

Opening Inventory → **Inventory** you already have

Purchases → **Inventory** you bought throughout the year

Closing Inventory → **Inventory** you have at the end of the year. This is not a part of the cost of goods sold because we haven't sold it, so we subtract it.

$O.I + Purchases - C.I = \text{Cost of Goods Sold}$

$Sales Revenue - Cost of goods sold = \text{Gross Profit}$

$Gross Profit - All Expenses = \text{Net Profit}$

We have to subtract tax and interest to get **Profit after interest and tax**

$P.A.I.A.T - Dividends = \text{Retained Profit}$

Ratio Analysis

Measures the performance of the business in comparison to previous years.

2 Parts

- 1) Profitability Ratios
- 2) Liquidity ratios

Profitability Ratios

Measure of the profitability.

Gross Profit Margin

Gross Profit/Sales Revenue x 100 = G.P.M
Company's **gross profit per dollar revenue**

Net Profit Margin

Net Profit/Sales Revenue x 100 = N.P.M

The **net profit per dollar of revenue**

Return on Capital Employed

Net Profit/Capital Employed (money put in the business) x 100 = ROCE

How much **money you get back per dollar invested**

Capital Employed = Shareholders Equity (retained earnings and equity) + Long term liabilities

Liquidity Ratios

Liquid Assets → Something that can be converted into cash quickly

Current Ratios

Current Assets/Current Liabilities

How **capable** a business is of **paying off its 1 year debt**.

Asset/Acid Test Ratio

(Current Assets — Inventory)/Current Liabilities

Problem with current ratios is that inventories are included, but it is not 100% that they sell. So, in the acid test ratio we subtract inventory to get a general idea of the worst case scenario (if no inventory is sold).

If the current ratio is too less that means you can't pay it back, but if it is too much > 2 then you have too much inventory.