TOPIC 1: THE NEED FOR BUSINESS FINANCE

Finance is used to pay revenue and capital expenditure and the failure to generate finance will lead to shut down of the business.

1. WHY BUSINESSES NEED FINANCE

Definition: Finance is the amount of money a business needs to buy assets and pay expenses.
The main reasons why businesses need finance A business needs finance for several business activities. These can be:

Factor	Description
1. Start-up Capital	It is the finance used by the business to pay for essential fixed (Land, Building, Car etc.) and current assets (Needs to buy inventories before it can start the business) start up capital is used to setup the business in its initial stages.
2. Capital for expansion	Businesses need finances for expansion by purchasing fixed assets or investing in new product development.
3. Additional working capital	A business needs finance to pay for capital expenditure or revenue expenditure.
4. Research and Development	This is when a business needs to research to develop new products or invest in new marketing strategies. [the same answer for uses of cash in business.

Working capital

Definition: It is the amount of capital that is used to meet the day-to-day expenses of a business such as fuel, bills, raw material etc. It is important because it is regarded as the bloodline of a business. If any business fails to pay off suppliers or pay off the bills it might be forced to shut down. The way to improve the working capital is ask your debtors to pay you quickly and delay payments to creditors. This helps to keep more cash into the business. It can be calculated with the following formulae:

[Working Capital = Current Assets* – Current Liabilities*] –> Part of the definition

* Current Assets: Short term assets. These are held in the business for less than a year
* Current Liabilities: Short term liabilities. These have to paid off within a year

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2. REVENUE EXPENDITURE AND CAPITAL EXPENDITURE

(1) Definition | Revenue expenditure: Money to be spent on day-to-day expenses, for example wages, fuel and rent. These are regular expenditure that give benefit over the short term.

1 mark definition, 1 mark for example

(1) Definition | Capital Expenditure: Amount of money spent on non-current assets which will last for more than one year. E.g. Building, Car etc. These expenses are irregular and give benefit over a long-term or over a number of accounting periods.

(1) Revenue Expenditure are used to maintain the life on an assets.

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[8. marks Essay] 'COPY PASTE THIS ESSAY'

Significance of the distinction between revenue expenditure and capital expenditure

It is important to distinguish between revenue and capital expenditure because of the following reasons:

1. Different impact on the business: These are two different kinds of business expenditure and have significantly different impacts on a business. Revenue expenditure is a regular expenditure, gives benefit over the short term, maintains rather than enhances assets. Capital expenditure is long-term, irregular, and produces benefit (assets) over a number of accounting periods.

2. Different in terms of how they are financed: They are almost certainly financed in different ways. Capital expenditure more likely to be financed with debt/loan financing whereas revenue expenditure is usually financed with better management of working capital, trade credit, credit cards etc.

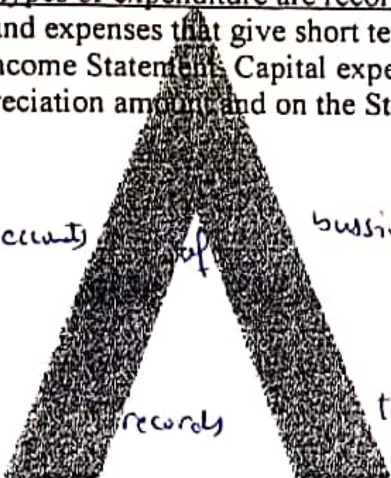
3. Different in terms of how these types of expenditure are recorded in financial accounts: Revenue expenditure is on assets and expenses that give short term benefit to the business (1 year) and recorded in full on the Income Statement. Capital expenditure will be recorded on the Income Statement as a yearly depreciation amount and on the Statement of Financial Position as asset valuation.

Define with example then start

There are two financial accounts of bussiness

i) The income statement

ii) The balance sheet which records the details of the assets and liabi



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TOPIC 2: SOURCES OF FINANCE

1. SHORT-TERM FINANCE AND LONG-TERM FINANCE

1 mark definition
1 mark example

Short-term
Definition: These sources of finance provide for the working capital for day-to-day running of business operations. These types of sources have to be paid back within the year, example overdraft, trade credit etc.

Long-term
Definition: These sources of finance provide for a long term, which is more than a year. Usually used in the case of fixed assets, finance take overs etc. example :- Selling shares, share holders.

2. INTERNAL SOURCES

Definition: An internal source of finance is the one that exists within a business. Following are the internal sources of finance:

1. Retained Profits
2. Sales of assets
3. Sale and Leaseback
4. Working Capital

• For every source you have to remember
i) 1 advantage and 1 dis adv
ii) All the sources can be tested as seperate source

1. Retained Profit

Definition: It is the profit after tax, that is reinvested into the business. It is a recommended source of finance since there is no cost of borrowing involved and the company doesn't need to sell more shares which maintains the owners control over the company. However, might not be sufficient enough to finance large projects. Furthermore new businesses won't have it and keeping profits in the business reduces payments to owners. Recommended for revenue expenditure and large businesses.

→ This is a short term source of finance which is mainly used for small scale expansion or day to day expensing.

2. Sale of assets

Definition: Businesses often generate funds by offering their idle assets for sale like machinery, land etc. in order to fund a particular project. It is recommended source since no cost of borrowing and it makes better use of the tied up capital however not available to new businesses and fixed assets are less liquid and take time to sell.

3. Sale and Leaseback

Definition: In this a firm sells valuable assets and lease them back again. This allows the firm to gain capital from the sale as well as the firm still continues to use the asset which prevents disruptions in the business. However now the firm needs to pay for the use of asset which was previously free which reduces long term profits.

4. Working Capital

Definition: As discussed earlier the firm can better manage its working capital. This can be done through delaying payment to suppliers and asking debtors to pay quickly. This method is beneficial since it has no cost of borrowing however this might harm the relationship of the business with its suppliers and its customers. The suppliers might not be willing to supply or might not allow discounts on a longer credit period. Furthermore, customers would be reluctant

This is a method where the business encourages to recieve payments quickly and delay expenditure

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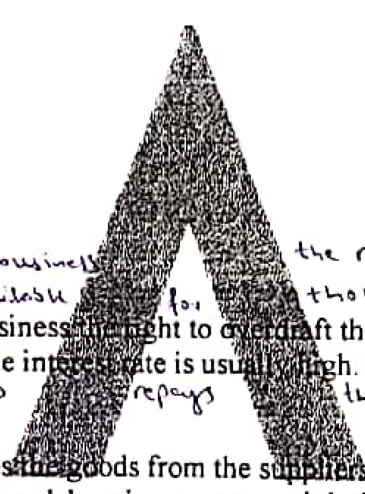
to but form this business due to shorter credit periods, which might reduce sales and the competitiveness of the business which will ultimately lower profits in the long run.

3. EXTERNAL SOURCES

Definition: When individuals, other businesses, or organizations such as banks or government provide capital to the business is known as external source of finance. Following are the external sources of finance:

1. Overdrafts
2. Trade Credit
3. Debt-Factoring
4. Hire purchase
5. Leasing
6. Bank loans
7. Debentures
8. Share capital
9. Venture capital
10. Mortgages
11. New partners
12. Micro-finance
13. Crowd funding
14. Government Grant



1. Overdrafts

Definition: The bank gives the business the right to overdraft the bank account. It is a flexible way to obtain finance, however the interest rate is usually high. Hence, its recommended that this method is only used if the business repays the amount quickly.

2. Trade Credit

Definition: The business purchases the goods from the suppliers and asks to pay back after sometime. It has no interest but long delays in payments might lead to bad relations with the suppliers.

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3. Debt Factoring

Definition: This is called buying a company's debts of a firm for immediate cash. This is usually done when a debt factoring agency buys off a company's debt. These agencies may offer 90% of an existing debt. This method is beneficial since the firm can quickly clear its debts however the company incurs a loss from the amount it had to receive.

4. Hire Purchase

Definition: Also, known as installment buying. The business gives a down payment which a proportion of the cost of the asset and the rest is paid in monthly installments. After the last installment is paid the business acquires the asset. It is beneficial since it is easier to buy fixed assets even when the business lacks finance, however down payment and interest needs to be paid.

→ Evaluation Comment: This method is beneficial when the firm acquires the asset for the long run, and the need is urgent for today.

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5. Leasing
Definition: It is a rental agreement. The firm uses the assets by paying monthly payments but does not purchase it. It saves the cost of down payments and maintenance is carried out by the leasing firm however it is usually more expensive than buying the asset.

6. Bank Loans
Definition: Money obtained from a bank to finance a business need. It is a fast way to borrow money and specially with large companies the cost of borrowing is low. However, the original amount must be repaid and several banks approve it against a collateral like land, building, machinery, and in case the business fails to pay the debt the banks reserves the right to sell its property.

7. Debentures
Definition: These are certificates issued by the companies with the objective of raising funds. It is important to note that a debenture holder serves the purpose of a creditor for the company.

8. Share capital
Definition: Private limited companies can raise capital by selling shares to friends and family where as a public limited company raise funds by selling its shares through the stock exchange. It has no cost of borrowing and amount doesn't have to repaid. However instead of interest dividend has to be paid and the original owners might lose ownership if too many shares are sold.

9. Venture capital
Definition: This when small companies who cannot raise finance through stock exchange gain long term investment from venture capitalists. These can be organizations or wealthy individuals who take massive risk with a small business.

10. Mortgages
Definition: These are long-term loans granted by financial institutions solely for the purpose of land and buildings. The land or building is used as security for the loan. This source is popular with small business to acquire land.

11. New partners
Definition: For existing looking to grow or expand the business, a source of funding may be to bring in additional partners into the business. These partners can be active partners or silent partners. Active partners can invest their own money in the business and have a say in the operation of the business. Silent partners are similar to investors, where they invest their money in the partnership, but they are not involved in the daily operations. (Advantages and Disadvantages of a Partnership)

12. Micro-finance
Definition: It is providing financial services and small loans to poor people who traditional banks would not cater to.

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13. Crowd funding

Definition: Crowdfunding is the practice of funding a project or venture by raising money from a large number of people. Each individual contributes a small amount but due to millions of people the venture is able to get a lot of money. Example: Snapchat was crowdfunded.

14. Government Grant

Definition: These are sums of money given to entrepreneurs or business for a specific purpose. The advantage is this money doesn't have to be paid back however there is a lot of competition for these grants and the amount is usually fixed so the businesses needs to exceptionally promising to obtain it.

Factors influencing the choice of sources of finance

Factor	Influence
1. Cost	The firm needs to consider the cost of the source of finance before finalizing an option. For example, if the loans are expensive to acquire due to high interest rates, options like retained profits and sale of assets should be considered.
2. Flexibility	If the firm is looking for flexibility it should avoid sources of finance like debentures, mortgages and consider more short-term sources like brank over drafts and trade credit.
3. Need to retain control	Business might have an objective to retain control in that case options like bank loans, trade credit, sale of assets should be considered instead of issuing more shares or bringing a partner.
4. The use to which it is put	If the use of the loan is expansion then venture capital, debentures and leasing might be considered however if the need is short term like meeting monthly expenses a bank loan or trade credit should be sufficient.
5. Level of existing debt	If the existing debt is high for the business options like bank loan are not advised since the business will be highly geared and banks would be reluctant to lend. In this case other sources like issue of shares, venture capital, sale of assets should be considered. Remember to mention the gearing ratio: $\text{Gearing Ratio} = \frac{\text{non-current liabilities}}{\text{capital employed}} \times 100$ Higher the gearing the worse it is for the business.

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Q. Analyze the importance of calculating cost?

Cost :- These are expenses that the business have to pay to engage in its trading activities.

TOPIC 3: COSTS 5–8 mark question

1. COST INFORMATION

Every firm needs to have accurate cost data for the following reasons:

Reason	Description
1. Calculate Profit/Losses	This helps the business take decision that have the lowest costs to maximize the profits.
2. Comparisons (Compare cost to the performance)	Costs helps to make relevant comparisons to gauge company's performance. Data on costs can help the company check whether their methods are working or not and assist in deploying appropriate strategies.
3. Resource Allocation	Cost data can help managers decide which resource to use. Example if wages are low the company should consider using labor intensive methods of production.
4. Preparer Budgets	Cost data can help preparer budgets for the future. This can help develop target to work towards and actual costs levels can be compared with budgets to see the performance department wise.
5. Pricing	The firms can adopt a cost-plus pricing strategy in which a certain mark-up is added to the cost price to calculate the selling price. Furthermore, contribution pricing can also be done where the price is set above the variable cost because any price above it will make a positive contribution to the fixed costs.

2. REVENUES, COSTS AND PROFITS

Definition | Revenue: It is the income that a business receives by selling its goods and services. It can be calculated with the following formulae:

$$\text{Revenue} = \text{Quantity sold} \times \text{Average selling price}$$

Definition | Costs: These are expenses that a business has to pay to engage in its trading activities. There are several types of costs in a business:

Type	Description
1. Fixed Costs	This is the cost that does not vary with the production level. These have to be paid by the business irrespective of the production level. Example: Rent, Insurance, Building etc.
2. Variable cost	This is the cost that varies directly with the production level. These costs increase as the production rises. Example: Wages, cost of raw material etc.
3. Semi-Variable Costs	These are costs that have fixed and variable elements. Example: Telephone bill, the line rent is fixed and the cost to make an extra call is variable.
4. Total Cost	These are the total costs incurred by the firm, which included the fixed and the variable cost. $\text{Total Cost} = \text{Fixed cost} + \text{Variable Cost}$
5. Average Cost	This is known as the per unit cost of production. This is calculated by the formulae: $\text{Average Cost} = \frac{\text{Total Cost of Production}}{\text{Total Output}}$
6. Marginal costs	This is the cost of producing one extra unit of output.

Drawbacks: Cost is an estimate figure because there are several methods to calculate it. Cost is only a quantitative variable and does not highlight the qualitative features of a product or a business decision.

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Direct and Indirect Costs

Another way to classify costs is to divide them into direct and indirect costs.

1. Direct Costs: These costs can be directly related to the production of a product and vary directly with the level of output. Example: Raw material, fuel etc. direct cost are deducted from the revenue to give gross profit.

2. Indirect Costs: These are overheads that cannot be allocated easily to the production of a particular product but is associated to the business as a whole. Example: Advertising, electricity etc. indirect cost are deducted from the gross profit to give net profit.

Definition | Profit: It is regarded as the excess of revenue over costs. It can be calculated with the following formulae:

$$\text{Profit} = \text{Total Revenue} - \text{Total Cost}$$

" = Output – B.E × contribution

the output can be maximum or current output depending on the question

3. BREAK-EVEN ANALYSIS

Definition: Break-even output is the level of output or production at which the total costs are exactly same as the total revenue. IT is the point where a business makes neither profit or loss. Beyond the break-even point the business will make a profit and below this point will make a loss.

4th calculation – calculation of missing variable

Break-even Charts

Definition: This is the graphical representation of calculating the break-even point. These graphs show how costs and revenues of the business change with sales. They show the level of sales a business must make in order to break-even.

Example:

	Amount
Fixed Costs	$5,000
Variable Cost/Unit	$3
Selling Price/Unit	$8
Maximum Output	2,000 Units
Current Output	1,500 Units

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Methods to improve B.E

- Reduce the fixed cost, this can be done by reducing expenses like rent, insurance, etc.
- Increase the selling price, this can be done by making a better brand image, improving the quality etc.
- By reducing the variable cost, this can be done by arranging a cheaper supplier, or utilising the resources more efficiently.

Question:

(a) Draw a break-even chart from the above-mentioned data
(b) Calculate the break-even point using the formulae
(c) Calculate the margin of safety

Answer:

(a) Whenever there is a question to draw the break-even chart make the following FOUR calculations:

1. Total Revenue = SP x Max Output	8 x 2000 = $16000
2. Total Variable Cost = VC x Max Output	3 x 2000 = $6000
3. Total Fixed Cost = Give in the Question	$5000
4. Total Cost = TVC + TFC	$6000 + $5000 = $11,000

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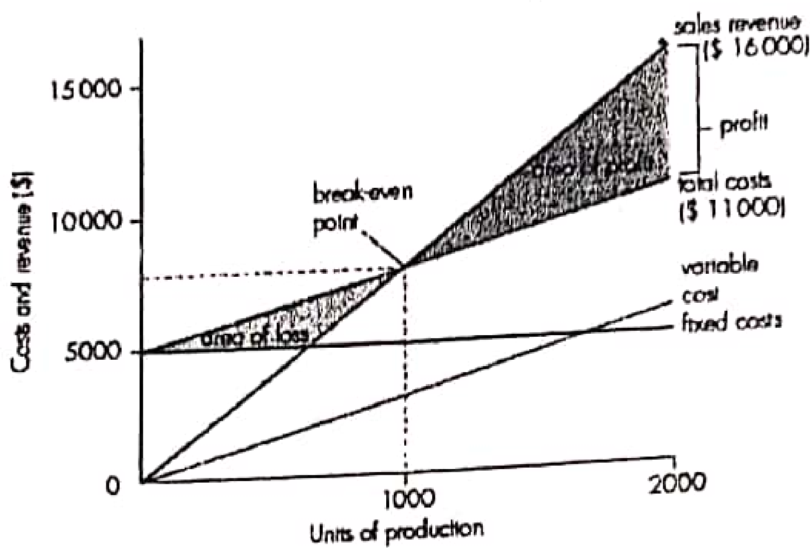

(b)

$$\text{Break-Even Point} = \frac{\textit{Total Fixed Cost}}{\textit{Contribution Margin (Selling Price} - \textit{Variable Cost)}}$$

$$= \frac{\$5000}{\$8-\$3} = 1000 \text{ units}$$

(c)

Margin of Safety

Definition: The amount by which the sales exceed the break-even point, or in other words the range of output over which a profit can be made. This is the distance between the current output and the break-even point.

Margin of Safety = Current Output – Break-even level of output
= 1500 – 1000
= 500 units is the margin of safety

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(d) **Profits on Break-Even**

Profit = Margin of Safety x Contribution
= 500 x 5
= $2500

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Can be tested as 12 mark essay.

Advantages and Disadvantages of Break-Even Analysis

Part (b) of calculations. -> P-2

Advantages	Disadvantages
1. They can help take better location decisions. Since the location with a lower break-even would be preferred.	1. The break-even assumes that costs and revenues will always be represented by straight lines, however in reality this is not true. Some costs might not remain variable after a certain point.
2. It can help take better marketing decisions, since it can tell the changes to the break-even point due to changes in price.	2. Break even doesn't take into account semi variable counts. Which a partly fixed and partly variable. Example: Postpaid mobile bill, there is fixed line rent which includes certain minutes, after a certain limit, customers are charged per minute.
3. It can assist operations decisions with respect to fixed and variable costs. Machines with lower costs would be selected.	3. Break even assumes that all the units produced would be sold. This is an unrealistic assumption.
4. Break-even is easy to construct and interpret.	4. It assumes that fixed cost remains constant throughout the production. This is not true since after a point the company would need to invest in the factors of production to expand operations.
5. It helps to make comparisons between different options by constructing charts and amend changes to the break-even point.	

numerical data

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Evaluation :-

- It only represents the ~~qualitative~~ quantitive data and no qualitative information is mentioned. Hence, its recommended to use break even alongside other techniques like market R
- Break even can only provide the number of units you need to sell. the strategy will still be build by the marketing department.
- Depends on how reliable is ~~data~~ the data.
- Break even has more significance for departments like operations and finance which rely more on quantitative decision making and less for HR which have a greater proposition for qualitative judgement

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TOPIC 4: ACCOUNTING FUNDAMENTALS

1. INCOME STATEMENT

Definition: An income statement is the document that records all the revenues and costs incurred by the business and helps in the calculation of profits. If you look at the Income statement closely it basically represents the same formulae of profit.

$$\text{Profit} = \text{Revenues} - \text{Costs}$$

Income Statement	$
Sales Revenue	100,000
Less: Cost of Sales	(20,000)
GROSS PROFIT	**80,000**
Less: Other Expenses 1. Wages (5000) 2. Rent (10,000) 3. Depreciation (2000) 4. Advertising Expense (13000)	(30,000)
NET PROFIT OR OPERATING PROFIT	**50,000**
Less: Interest	(5,000)
PROFIT BEFORE TAX	**45,000**
Less: Tax	(10,000)
PROFIT FOR THE YEAR	**35,000**
Less: Dividends	5,000
RETAINED PROFIT / RETAINED EARNINGS	**30,000**

Main features of an income statement

Feature	Description
1. Revenue	The income that the business generates from selling goods or services
2. Cost of Sales	The actual cost of buying/producing the goods and services
3. Gross Profit	This is the profit calculated by deducting revenues from the cost of sales. This figure gives us the profit made just on the cost of sales and ignores other expenses.
4. Other Expenses	These are regarded as expenses that a business occurs other than just cost of production. These expenses are necessary for the entire business to function properly and are not directly involved with the production.
5. Depreciation	This is the fall in the value of a fixed asset over a time
6. Operating Profit / Net Profit	This is the profit made after all the costs have been deduced from the revenues.
7. Retained Profit	This is the profit investment back into the business after paying taxes and dividends.

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2. STATEMENT OF FINANCIAL POSITION

Definition: A balance sheet highlights the value of assets, liabilities and the capital employed at a particular time. This tells how much a business is worth. It is constructed on the accounting equation:

Assets – Liabilities = Capital

This shows us that worth of the business will increase its assets go up, or liabilities come down.

Statement of Financial Position

	$
1. ASSETS	
- Non-Current Assets	
Land	300
Building	200
Intangible Assets	200
- Current Assets	
Inventories/Stocks	50
Accounts Receivables / Debtors	30
Cash	20
TOTAL ASSETS	**800**
2. LIABILITIES	
- Current Liabilities	
Accounts payable	90
Bank Over draft	40
- Non-Current Liabilities	
Long term bank loan	60
TOTAL LIABILITIES	**190**
NET ASSETS (TOTAL ASSESTS – TOTAL LIABILITES)	**610**
3. SHAREHOLDER'S CAPITAL	
Share Capital	110
Reserves and Retained Earnings	500
TOTAL EQUITY	**610**

1. Assets

Definition: These are items owned by the business. There are THREE types:

Type	Description
1. Fixed/Non-Current	These are assets which are kept in the business for more than one year. Example Land, Buildings, Cars, etc.
2. Intangible	These are assets that do not exist physically but still have a value. Example: Brand names, patents, image, goodwill, intellectual property etc.
3. Current	These are assets that are held in the business for a short period of time. Example: Cash, inventories, accounts receivables.

2. Liabilities

Definition: These are items owed by the business.

Type	Description
1. Long-term/Non-current	Loan which have to be repaid after one year. Example: Long term bank loan, debentures etc.
2. Current Liabilities	Amount owed which must be repaid within one year. Example: Creditors, bank over draft etc.
3. Net assets	This refers to the value of a company's assets minus its liabilities.

3. Shareholders Capital / Shareholder's Equity

Definition: It is the total money invested into the business and is used to purchase a range of assets including machinery and inventories.

i) Share Capital: This is the money invested into the business by its owners through selling of shares. → just mention them.

ii) Reserves: These are company's accumulated retained profits.

3. RATIO ANALYSIS These can be tested as 3 marks calculation in P-2 and 12 marks essay → P-1

Definition: Ratio analysis is used to evaluate various aspects of a company's operating and financial performance such as its efficiency, liquidity, profitability and solvency.

Profitability Ratios

Definition: These measures the profits of the company as compared to its revenue. There are TWO profitability ratios:

1. Gross Profit Margin
2. Operating Profit Margin / Profit Margin

1. Gross Profit Margin

Definition: Gross profit margin shows the gross profit as a percentage of sales. This ratio should be higher the better. This ratio can guide the firm regarding the pricing policies and is a useful tool for managers in terms of decision making.

$$\text{Gross profit margin} = \frac{\text{Gross Profit}}{\text{Sales Revenue}} \times 100$$

Examiner will give you the value of the ratio and can ask you to calculate either the Net profit or Gross profit.

2. Operating Profit Margin / Profit Margin

Definition: Operating profit margin shows the operating profit as a percentage of sales. This ratio should be higher the better. A high net profit margin suggests the other overheads like electricity bills, salaries etc. are low and sale price in rising or sales are increasing which is increasing profits.

$$\text{Operating Profit Margin / Profit Margin} = \frac{\text{Operating Profit}}{\text{Sales Revenue}} \times 100$$

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The same points can be used if the Essays states the methods to improve profitability?

Methods to improve Profitability Ratios

Method	Description
1. Reducing Direct Costs (Improves GP and OP Margin)	1. The firm can use cheap material to reduce the direct costs however this will damage the repute of the company and customers might discontinue which might reduce sales and hence reduce the GP and OP Margin. 2. Reduce labor costs by moving to a low-cost country however their might be quality issues and the firm might experience communication problems. 3. Introduce automation like robots to speed up production and achieve EOS however this will reduce the operating profits since if the depreciation of these machines is high OP Margin will fall. Furthermore, more staff needs to be retrained which might increase training costs reducing the short-term profits. 4. Firms might also think to reduce wages. This will reduce the motivational levels resulting lower productivity and quality. Furthermore, the firm might experience high labor turnover. Several employees might join another high paying company increasing the firms cost of recruitments. Lastly if trade unions are strong the company might experience resistance from trade unions which can lead to bad publicity.
2. Increasing Prices (Improves GP and OP Margin) it depends on the P.E.D. this strategy will only work if P.E.D is inelastic	The firms can increase prices by keeping a check on their variable costs to increase the profit margins. This might reduce the demand and customers might switch to competitor's product. Furthermore, firms might be blamed for profiteering which might result in actions from the government.
3. Increasing Sales (Improves GP and OP Margin) no. of units	The firm can launch marketing campaigns and launch innovative products to increase sale. However, this might increase the cost of production and if advertising cost is more than the sales then the profits will actually decline.
4. Reducing Overheads (Improves OP Margin)	Reducing costs like rent, promotion and management costs by moving to a cheaper place, reducing promotions and delayering can help increase the profits. However cheap location could harm the brand image, reducing promotion might reduce sales and fewer managers or lower salaries might reduce efficiency.

Liquidity Ratios

Definition | Liquidity: It is the ability of a business to pay off its short-term debts. If the business cannot pay its suppliers for materials, or the business is unable to pay overdrafts it is said to be illiquid. The business that owes too much might be forced to stop trading and forced by creditors like banks and other businesses to sell business assets to pay off the debts.

Definition | Liquidity Ratios: These rations measure the ability of a business to pay-off its short-term debts or liabilities.

(Methods) Evaluation :- 1) Depends on the type of the business

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2) - Profitability is also dependent on external variables hence those variables should be considered before the decision is finalized.

3) depends on the competitive strategy, if the market is highly competitive increasing prices will be less significant.

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- **1. Current ratio**

<u>Definition:</u> Current ratio gauges the ability of a business to pay off its short-term debts. A current ratio value of greater than 1 shows that the company is in a better position to pay off its debts. A ratio less than 1 can indicate serious cash flow problems since the company would have less assets to pay of the debts. An extremely high current ratio would mean too much working capital is tied up in unprofitable assets. An important point to note is that current ratio assumes that all the current assets can be quickly converted into cash which is not the case in reality. Idle current ratio 1.5 to 2.

$$\textbf{Current ratio} = \frac{\textit{Current Assets}}{\textit{Current Liabilites}}$$

2. Acid test/Quick ratio

<u>Definition:</u> Acid test provides a stricter analysis of a business to pay off its short-term debts. Inventories are deducted from the current assets since they are difficult to convert into cash. A ratio less than 1 can indicate serious cash flow problems since the company would have less assets to pay of the debts. An extremely high acid test ratio would mean too much working capital is tied up in unprofitable assets. Idle current ratio 1.0 to 2.

$$\textbf{Acid test/Quick ratio} = \frac{\textit{Current Assets} - \textit{Inventory(Stocks)}}{\textit{Current Liabilites}}$$

Methods to improve Liquidity Ratios

Method	Description
1. Sell fixed assets for cash	1. The company can sell its unused fixed assets. This will result in cash inflow improving the liquidity. However, if assets are sold quickly they might raise their true value and the firm will lose ownership of the asset as well. 2. The firm in this case might decide to lease-back the asset however then leasing chargers would reduce the profits.
2. Sell Inventories for Cash	1. Selling inventories for cash can help improve the acid test ratio. However, in order to sell inventories firm might have to give discounts which is reduce profitability. 2. The firm might also shift to JIT stock management to reduce the inventories in the business however JIT might not be effective if the demand increases and repeated orders might increase transportation costs which decreases profits.
3. Take long term loans to increase working capital	Long term loans can help increase the cash into the business however increases the gearing ratio and interest payments which will reduce profits. Furthermore, the business also has to give a collateral to acquire a loans and failure to repay might result in loss of the asset.

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Limitations of Financial Ratios

1. The value of the ratio itself doesn't hold much value and it needs to be compared with similar businesses to be more informative.

2. The value of accounts from which the ratios are created might be incorrect and can lead to misleading results.

3. The ratios can only predict problems but don't suggest methods to solve them. In this case, several other qualitative and quantitate methods must be discussed to reach an appropriate solution.

4. Comparison with other companies and evaluating employee's performance based on those figures might be disastrous. Since the other company might use different ways to value assets or have window dressed accounts which shows positive results. In this case the company's employee might be demotivated.

Uses and Users of financial accounts

Users	Description
1. Managers	1. Better decision making – help in expansion, change price levels etc. 2. Ratios provide a quick analysis to compare performance over the years.
2. Shareholders	1. How much profit a company is making. 2. Helps in investment decisions. 3. Gauge the worth of the business.
3. Creditors	1. Will tell the businesses ability to pay off debts. 2. Supplier might not give goods if the liquidity is poor.
4. Banks	1. Use them for giving loans. 2. Want to check the liquidity.
5. Government	1. Uses the accounts for taxes. 2. Monitor business activity.
6. Workers and Trade Unions	1. Check the statements for pay raise. 2. For better working conditions
7. Other businesses (Competitors)	1. Use them for comparisons. 2. Helps in deciding the value in take overs mergers.

Limitations of Published Accounts

1. These accounts don't show details about the sales and profitability of each good and service.
2. The future plans of the business about R&D and new products are not shown.
3. The quality of leadership and other qualitative variables like employee motivation is not shown by the financial data. These include the skills of the senior managers etc.
4. The information in the accounts is old and may not be relevant for the future.
5. These accounts might be window dressed. Window dressing is presenting the company accounts in a favorable light to influence the banks to lend more or encourage investors to buy more share. This can be done by overstating assets, reducing depreciation, giving stocks a higher value, delaying expenses till the accounts published etc.

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TOPIC 5: FORECASTING AND MANAGING CASH FLOWS

1. PURPOSES OF CASH FLOW FORECASTS

1. Difference between cash and profits

Cash is the physical movement of money within the business. Whereas profit on the other hand is the surplus after all the total costs have been deducted from sales revenue. This shows that a business that is profitable doesn't necessarily have to have cash and vice versa.

Example: A business sells goods worth $10,000 and It costed $5000 to make those goods. The profit comes out to be $5000. However, for the goods sold worth $10,000 only $5000 cash is received.

2. Why cash is important to a business?

1. Cash helps the business pay of its day to day expenses like workers, suppliers, etc.
2. Cash is essential for production of goods and services. The firm needs to buy raw material essential for production and pay of workers to make sure they keep working.
3. The business might have to liquidate its fixed assets due to unavailability of cash.

2. CASH FLOW FORECASTS IN PRACTICE

Definition | Cash Flow: It is the movement of cash into and out of a business over a period of time. It is also known as net monthly cash flow.

$$\text{Cash Flow} = \text{Cash Inflow} - \text{Cash Outflow}$$

Definition | Cash-flow Forecast: It is the estimate of a firm's suture cash inflows and outflows. A cash flow forecast has the following elements:

1. Cash Inflows
2. Cash Outflows
3. Opening Balance
4. Closing Balance

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1. Cash Inflows

Definition: These are payments in cash received by a business, such as those from customers or from banks in the form of a loan.

2. Cash Outflows

Definition: These are payments made in cash by a business, such as those to suppliers and workers.

3. Opening Balance

Definition: This is the business's cash position at the start of a month.

4. Closing Balance

Definition: The balance of cash at the end of the month. It can be calculated with the following formulae:

$$\text{Closing Balance} = (\text{Cash Inflow} - \text{Cash Outflow}) + \text{Opening Balance}$$

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Sample Exam Question: **(O/N 2016, V2) | Q2**

	Month 1 ($)	Month 2 ($)	Month 3 ($)	Month 4 ($)
Cash inflows:				
Cash sales	10000	10000	10000	10000
Trade receivables	2000	2000	2000	15000
Total cash in	12000	12000	12000	25000
Cash outflows:				
Factory rent	2000	2000	2000	2000
Cost of sales	8000	16000	8000	8000
Insurance*	12000	0	0	0
Electricity**	3000	0	0	3000
Total cash out	25000	16000	10000	13000
Opening balance	10000	(3000)	(9000)	(7000)
Closing balance	(3000)	(9000)	(7000)	Z

*Insurance is paid once a year

**Electricity is paid once a quarter (every three months)

Question: Calculate the value of Z

Answer: Closing Balance = (Cash Inflow – Cash Outflow) + Opening Balance
= ($25,000 – $13,000) + (-$7000)
= $5000

Advantages and Disadvantages of Cash Flow Forecasts

Advantages	Disadvantages
1. It can be used to predict cash imbalances in terms of amount and duration. This can help the business managers plan ahead. If the business expects surplus cash it can plan investment options where as if there is liquidity problem it can apply for loans now.	1. Mistakes can be made when prepaying inflows and outflows. This problem might me more for new entrepreneurs who are inexperienced.
2. It can allow government authorities to rely on it to certain extent for calculation of taxes.	2. Inaccurate assumptions about the future level of sale or price of the products. This may be due to poor market research.
3. Suppliers can look at the cash flows to assess the liquidity position. Businesses with good cash reserves might get longer credit periods and relaxed terms of payments.	3. Unexpected increase in costs may lead to major inaccuracies. These can be due to major external environmental changes. Example: Minimum wage might go up, oil prices suddenly spike up, unexpected machinery breakdown interest rates increase etc.
4. Forecasts will aid potential investors and lending institutions to assess financial needs and requirements of a new business and its ability to pay off debts and according to that give the finance.	4. These figures is the statement might be window dressed to attract investors. Inflows might be overstated whereas outflows might be understated.

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Evaluation: The above-mentioned disadvantages does not make cash flow useless however they should be used to caution. Researching the market reading prices, suppliers, cost of raw material etc. can improve the accuracy. Furthermore, of the firm hire specialists and use technology like spreadsheets to construct and monitor cash-flow forecasts since it would not only make them simpler but also quicker to amend.

3. METHODS OF IMPROVING CASH FLOW

1. Reasons for cash flow problems

Reasons	Description
1. Lack of planning	This is when a business fails to forecast the timing of the expenditure and income which leads to the crises.
2. Poor credit control	This is when the credit control department doesn't collect debts on time. This leads to delayed payments or bad debts where customers don't end up paying at all.
3. Extended credit periods	This happens when a business gives an extended credit period to attract customers. However, if the policy is too extended it might face cash difficulties.
4. Overtrading	This is when a business expands to quickly without organizing funds to finance the expansion. This happens because expenses of labor and raw material have to be paid before the firm can generate any revenue.
5. Unexpected events	When factors outside the control of the business lead to cash flow problems. Example: Minimum wage might go up, oil prices suddenly spike up, unexpected machinery breakdown, interest rates increase etc.

2. Methods of improving cash flow

There are TWO ways to improve cash flow

1. Increase cash inflows
2. Decrease cash outflows

1. Increase cash inflows

Use all the sources of finance mentioned in Topic 2 Source of Finance

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2. Decrease cash outflows

Method	Description
1. Delay payments to suppliers	Cash outflow will reduce in the short run however suppliers might not be willing to supply or might not allow discounts on a longer credit period.
2. Delay spending on capital equipment.	Cash outflow will reduce however business efficiency might call due to poor equipment leading to competitors taking an edge over the company. Furthermore, it might restrict expansion.
3. Use leasing not buying capital right away	Since not cash outlay is required will reduce outflow however asset would not be owned by the businesses which restricts its freedom of use and furthermore leasing payment will reduce profits.
4. Cut overheads	Cut expenses like lighting and promotion. This will improve the efficiency however lack of promotion might reduce demand for the product reducing sales and ultimately profits. Furthermore, in order to reduce overheads firm might need efficient machinery which increases outflow.

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