

Unit 2: Finance for Business

Learning Aim C:

Understand how businesses measure success and identify areas for improvement

Topic C.1 Understand how businesses measure success

Topic C.2 Understand how businesses can be more successful



Learning aim C: Understand how businesses measure success and identify areas for improvement

Topic C.1 Understand how businesses measure success



Making a profit – learners should:

- . Understand cost of sales
- . Understand gross profit
- . Calculate gross profit (formula will not be given in the assessment) } $\text{gross profit} = \text{revenue} - \text{cost of sales}$
- . Understand the impact of positive and negative gross profit on businesses
- . Understand net profit
- . Calculate net profit (formula will not be given in the assessment) } $\text{net profit} = \text{gross profit} - \text{expenditure}$
- . Understand the impact of positive and negative net profit on businesses

Measuring success by looking at financial statements – learners should:

- . Understand what financial statements are – documents that record the financial activities of a business, sometimes required by law, including income statement (profit and loss account) and statement of financial position (balance sheet)

Income statement (profit and loss account) – learners should:

- . Understand the purpose of an income statement (profit and loss account)
- . Understand how to complete an income statement (profit and loss account) from given figures, including:
 - . opening account (top section of the income statement) – includes figures for revenue (turnover) & cost of sales
 - . calculates the amount of gross profit
 - . expenses/overheads (bottom section of the income statement)
 - . calculate profit.
- . Understand stability ratios (formulas will not be given in the assessment)
 - . gross profit margin
 - . net profit margin

Learning aim C: Understand how businesses measure success and identify areas for improvement

Topic C.1 Understand how businesses measure success



Statement of financial position (balance sheet) – learners should:

- . Understand the purpose and format of a statement of financial position (balance sheet)
- . Understand assets and liabilities - . fixed assets . current assets. . long-term liabilities . current liabilities.
- . Understand and complete a statement of financial position (balance sheet) with given figures, including: . assets . liabilities. . capital
 - how the business is funded (money invested in the business to generate revenue) from:
 - internal sources – money from owners/shareholders (share capital) or retained profits – external sources – finance raised from outside of the business
- . Working capital (formula will not be given in the assessment) } $Working\ Capital = Current\ assets - Current\ liabilities$
- . Understand liquidity ratios (formulas will not be given in the assessment)
 - . current ratio } $Current\ ratio = \frac{Current\ assets}{Current\ liabilities}$
 - . liquid capital ratio } $Liquid\ capital\ ratio = \frac{Liquid\ capital}{Current\ liabilities}$

Topic C.2 Understand how businesses can become more successful

Learners should:

- . Understand ways in which a business can increase profits.
- . Understand financial statements and actions that arise from these statements.

C: Understand how businesses measure success and identify areas for improvement

C.1 Understand how businesses measure success

Profit

- Profit when revenue greater than expenditure
- Profit can vary but a profit is needed to keep the business going

Example 1: Credit

- Sales revenue may be high but with credit terms at 90 days the business has to wait for payments creating cash flow problems

+

Example 2: Stock

- A business holding a lot of stock has its cash tied up in the goods are not sold

+

Example 3: Assets

- A start-up business may have spent a lot of cash on buying premises, vehicles etc. leaving it short of cash



Cash flow - Profits

- All the businesses in the examples are profitable but have **cash flow** issues – short of cash - that cause them serious financial problems, and even insolvency (bankrupt).

Ultimately, **profit** needs to be made for the owners – a return on their investment - for a sole trader, partnerships or shareholders.

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C.1 Understand how businesses measure success

...ing a profit

All businesses need to make a profit – even social enterprises, who can then use the profit for their cause.
The TWO types of profit we are interested in are GROSS and NET PROFIT

Public Limited Companies:

...have to show a statement of comprehensive income - profit and loss - gross profit, operating profit, profit before tax, profit (+/- tax)

Revenue
(Sales)

- Direct costs

Cost of sales: raw materials + fuel + workers wages

£££

Gross Profit

Gives an overall picture of the financial performance
But not include indirect costs

- Indirect costs

Indirect: rent + management/administration salaries

££

Operating Profit

Profit after deducting all operating costs
But not include profit from investments or tax or loan payments

- Taxation and interest

Companies pay corporation tax on their profits

£

Net (After Year) Profit

Profit from all sources of income with all costs deducted
End of year profits can be used in a variety of ways

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C.1 Understand how businesses measure success

Calculating a profit



$$= \text{Revenue} - \text{Cost of sales}$$



$$= \text{Gross profit} - \text{expenditure}$$

PREVIEW

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C.1 Understand how businesses measure success



Task 1.

List your monthly cash inflows and outflows

Jewellery store	
Revenue	£150,000
Cost of sales	£25,000
Gross profit	
Expenditure	
Utility	£1,000
Insurance	£1,000
Wages	£60,000
Advertising	£5,000
Other	£6,000
Tax	£5,000
Net profit	

Book store	
Revenue	£260,000
Cost of sales	£110,000
Gross profit	
Expenditure	
Utility	£15,000
Insurance	£2,000
Wages	£80,000
Advertising	£8,000
Other	£6,000
Tax	£15,000
Net profit	

Building Co.	
Revenue	£650,000
Cost of sales	£200,000
Gross profit	
Expenditure	
Utility	£20,000
Insurance	£10,000
Wages	£160,000
Advertising	£2,500
Other	£75,000
Tax	£45,000
Net profit	

Gross profit = revenue - cost of sales
 Net profit = gross profit - all expenditure

C: Understand how businesses measure success and identify areas for improvement

C.1 Understand how businesses measure success

Financial statements record the financial activities and resources of a business – require by law if a limited company.

Income statement = profit / loss account

Balance sheet = statement of financial position

Financial statements

Income statement (profit/loss account)

An **income statement** is a record of a business's trading activities over the last year – it will show the profit/loss for that year. It will include:

Trading account: income – expenditure = profit/loss

Opening stock: value of stock at the start of the year

Purchases: stock bought during the year

Stocktaking: value of closing stock x value of stock
closing stock from one year = opening stock of new year

Cost of goods sold = opening stock + purchases – closing stock

Profit – loss account: Gross profit + expenditure = Net profit (- tax for a limited company)

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C.1 Understand how businesses measure success

Income statement (profit/loss account)



Task 2.

Explain the following terms:

Sales returns:

Overhead:

Delivery/freight expenses:

Depreciation:

Net Profit:

Sample Company Income Statement For the year ended December 31, 2019	
Revenue	
Sales	\$250,000.00
Less: Sales Returns	\$10,000.00
Less: Discounts and Allowances	\$2,000.00
Net Sales	\$238,000.00
Cost of Goods Sold	
Beginning Inventory	\$1,000.00
Less: Ending Inventory	\$4,000.00
Overhead	\$10,000.00
Total Cost of Goods Sold	\$15,000.00
Gross Profit	\$223,000.00
Operating Expenses	
Wages	\$100,000.00
Payroll taxes	\$15,000.00
Advertising	\$2,000.00
Repairs & Maintenance	\$1,000.00
Rent/Lease	\$25,000.00
Delivery/Freight Expense	\$500.00
Utilities/Telephone Expenses	\$1,000.00
Insurance	\$800.00
Office Supplies	\$500.00
Depreciation	\$1,000.00
Meals	\$0.00
Entertainment	\$0.00
Other Expenses	\$500.00
Total Operating Expenses	\$147,300.00
Operating Income (Loss)	\$75,700.00
<i>Less: Non-Operating Expenses</i>	
Interest expense	\$500.00
Profit (Loss) Before Taxes	\$75,200.00
Less: Tax Expense	\$22,000.00
Net Profit (Loss)	\$53,200.00

PREVIEW

C: Understand how businesses measure success and identify areas for improvement

C.1 Understand how businesses measure success

Statement of financial position (balance sheet)



Statement of financial position or balance sheet must be done each year for a limited company. It lists what the company owns and what it owes others. It is only accurate for the day it is produced.

Assets: what it owns and the resources it has

Liabilities: what is owed to others (individuals or businesses)

Capital: what is owed to the owners of the company

Balance sheet must balance based on the formula: Assets = Liabilities + capital

Example: Machine bought for £10,000, business pays £5,000, owes the supplier £5,000

Asset = £10,000 – Liability £5,000 + Capital £5,000. When the money owed is paid: Asset £10,000 – Liability £0 + Capital £10,000

Rules for balance sheet – how:

- . **Fixed assets** shown first then **current assets**
- . **Current assets** listed in order) stock, debtors, money in the banks, cash in the business
- . **Working capital** = current liabilities – current assets
- . **Net assets** = capital in the business

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ing a profit

Statement of financial position (balance sheet)

Fixed assets: more than a year – can appear on balance sheets for several years e.g. buildings, equipment, vehicles, machinery, office equipment

Shown as 'at cost' – price paid for them or 'at net value' or 'book value'. This is cost price – less depreciation.

The value falls for most assets except premises + land.

Liabilities: what is owed to others (dividend, suppliers, banks etc)

- Current liabilities:** short term debts to be paid within a year. Usually trade creditors (supplies) + bank overdraft
- Long term liabilities:** more than a year e.g. loans and mortgages (loan capital)

Capital: money used to set-up the business for premises, equipment, stock etc. These assets have value.

Reserves: money kept in business – profits not paid to shareholders.

Known as **retained profits**. Reserves are often used for research & development, expansion etc

Current assets: liquid assets – can be turned easily into cash. Shown on a balance sheet in reverse order of liquidity.

Quicker a business can turn assets into cash the more liquidity it has.

More liquid = better cash flow e.g. able to pay its debts.

Working capital: money used to pay for the day-to-day expenses

Formula – working capital = current assets – current liabilities

Important: pays utilities, wages & stock
measures liquidity (cash flow)
need enough for expenditure + emergencies

C: Understand how businesses measure success and identify areas for improvement

Statement of financial position (balance sheet)

Profit and Loss Statement

££

Working capital

$$= \text{Current assets} - \text{Current liabilities}$$

££

Current ratio

$$= \text{Current assets} / \text{Current liabilities}$$

££

Liquid capital ratio

$$= \frac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}}$$

C: Understand how businesses measure success and identify areas for improvement

C.1 Understand how businesses measure success

Calculating a profit

ABC Ltd. Statement of financial position as at 31/12/2019 (2019)	
ASSETS	
Non-Current (fixed) Assets:	
Land and buildings	500
Machinery	1000
Current Assets	
Inventories (stocks)	80
Accounts receivable (debtors)	50
Prepaid expenses	10
	140
TOTAL ASSETS	1290
LIABILITIES	
Current Liabilities:	
Accounts payable (creditor)	65
Bank overdraft	65
	130
Non-Current (long-term) liabilities:	
Long-term bank loan	300
TOTAL LIABILITIES	430
TOTAL ASSETS - TOTAL LIABILITIES	860
Shareholders' Equity	
Share Capital	520
Profit and Loss Account Reserve (Retained Earnings)	340
TOTAL SHAREHOLDERS' EQUITY	860

PREVIEW

C: Understand how businesses measure success and identify areas for improvement

C.2 Understand how businesses can be more successful

Increasing profits

Improve efficiency

Maximize capacity

Reduce sub standard products

Improve profit and profitability

Increase prices

Reduce the cost of production

Improve methods of production

Reduce unprofitable aspects of the business

C: Understand how businesses measure success and identify areas for improvement

C.2 Understand how businesses can be more successful

Improve efficiency

- . There are many ways to improve efficiency in a business
- . Aim is to produce goods or service with minimum resources
- . Employee efficiency can be key

Reduce sub standard products

- . Quality control in production can reduce the number of sub standard goods
- . Each good rejected has cost implications
- . Less rejected goods = increase profitability

Increasing profits

Increase prices

- . Increasing prices will improve cash flow and profits
- . BUT higher prices can lead your customers to look elsewhere

Improve methods of production

- . There are many ways to improve efficiency in a business
- . Aim is to produce goods or service with minimum resources
- . Employee efficiency can be key

Maximise capacity

- . Maximising capacity improves efficiency and profitability
- . Units of price is produced, therefore profit can rise

Reduce cost of production

- . Often the first thing to assess is the cost of production
- . Maintaining the same quality whilst reducing costs is the challenge for businesses
- . Poorer quality goods can lead to a loss of customers

Reduce unprofitable aspects of the business

- . Many businesses, particularly larger ones will have aspects of its operation that are less profitable or loss making
- . Eliminating these will improve cashflow and profits



PREVIEW

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C.2 Understand how businesses can be more successful

Increasing profits



State an advantage and disadvantage of reducing the cost of production to improve profitability

State one consequence of increasing prices to improve profits

State two possible innovations for a business reducing production costs to improve profits

PREVIEW

. Identifying areas for improving cash flow and profitability can be very difficult and time consuming

. Once the area for improvement has been identified the difficulty is then how to remedy the problem

Difficulties in improving cash flow and profitability

. Decisions to improve cash flow and profitability can cause short-term issues e.g. moving production can incur costs before the benefits are seen

. Decisions to improve cashflow and profitability can adversely affect the reputation e.g. move production out of your home country – reduced quality of products

PREVIEW