**WHAT FINANCIAL ACCOUNTS DO BUSINESS USE TO MONITOR THEIR FINANCES?**

All organisation whether commercial or non-commercial need to keep financial record of their transaction to ensure they have enough money to pay their expenses. At the end of the year their financial performance is summarised in two important financial statements

1. Profit and loss account
2. Balance sheet

**WHAT IS A PROFIT AND LOSS ACCOUNT?**

A profit and loss (P&L) account shows the amount of income earned, expense incurred, and profit made by the business. It also shows

1. How much profit was paid out in tax?
2. How much was paid in dividends
3. How much was retained in the business for the future

*Basis Profit and Loss Account*

Sales 200

Less cost of sales 50

**Gross Profit** 150

Less expenses 40

Net Profit 110

Less corporation tax 50

Less dividends 20

**Retained earnings 40**

*Term from the Profit and Loss Account*

**Cost of sales** This is the cost of purchasing or making the product (Raw materials, purchases stock)

**Gross profit**

* This is the profit before any expenses, interest is deducted
* Low gross profit indicated that the cost of raw materials is too high, or the selling price is not high enough

**Expenses** These included items such as Rent, wages, Electricity, Light and heat

**Net Profit**

* This is the profit after expenses are deducted
* A low net profit indicated that the business expenses are too high

**Corporation Tax** This is tax that is paid by companies on their profits

**Dividends** This is a share of the profits that are paid to the shareholders

**Retained earnings** This is the profits that is left after all the expenses, cost and dividends have been taken out (It is an important source of long-term finance)

**WHAT IS A BALANCE SHEET?**

This is a statement of the wealth of a business. It shows all the assets (something the business owns) and liabilities (Owes) by the business at a specific date

**Fixed Assets** Theses are permanent items owned by the business. They can be tangible – they can be seen or touched (Building) or intangible – They can’t be seen (Good Will). Fixed assets show a bank how much security a business has when they are applying for a loan

**Current Assets** These are assets that are always changing during the year. And Included Debtors who are people who owe the business money

**Current Liabilities** These are debts that should be paid within one year. The included Creditors whom are the people the business owe money too

**Working Capital** This is the finance that is used for the day to day running of a business. It is usually gotten by subtracting the current assets figure from the current liabilities figure. It shows if the business has enough money to pay their short-term debts

**Finance By** This section show the source of long term finance that is raised by a business. It included ordinary shared, preference shares, Debentures and loans. It shows the borrowing in a business and if they can borrow more

**Ordinary shares** This is the value of share that have been issued to shareholders

Equity capital This is the amount of funds that are owned by the shareholders

**Capital Employed** This is the total finance that the company used in a year

**HOW CAN ACCOUNT BE INTERPRETED USING RATIOS**

Ratio analysis refers to the study of one piece of accounting data in relation to another piece of accounting data. There are 3 main types of ratio analysis

1. Profitability
2. Liquidity
3. Gearing

**PROFITABILITY**

These ratios show the effectiveness of a business in using its resources to generate profits. It includes the following ratios

1. Gross profit Ratio
2. Net Profit Ratio
3. Return on Capital employed
4. *Gross profit ratio*

This ratio is also known as the Gross Margin and Gross Profit Percentage. It is calculated by taking the Gross Profit figure and dividing it by the sale figure. Then multiply it by 100 to get a percentage. It is shown as a percentage. It shows the amount of Gross Profit the company will get from Sales. For example, a Gross Margin of 45% means that the business is earning 45c Gross Profit. The higher the Gross Profit the easier the business can pay its expenses

***Formula***: Gross Profit 100

x

Sales 1

A decline in the Gross Profit Margin can be due to the following

1. Increased cost of Sales – This can be due to higher material or production costs
2. Lower profit margins – This is because the selling price is low
3. *Net Profit Ratio*

This ratio is also known as the Net Margin and Net Profit Percentage. It is calculated by taking the Net Profit figure and dividing it by the sale figure. Then multiply it by 100 to get a percentage. It is shown as a percentage. It shows the amount of Net Profit the company will get from sales. For example, a Net Margin of 20% means that the business is earning 20c Net Profit. The higher the Net Profit Margin the higher the profits.

If the Net Margin falls (disimproves) it shows that the firm’s profitability has decreased and that it may be time for management to control its costs by deciding for example to cut wages, source cheaper raw materials or it should try to increase sales revenue.

***Formula***: Net Profit 100

x

Sales 1

1. *Return on Investment (ROI)*

This is also known as Return on Capital Employed. It is calculated by taking the Net Profit figure and dividing it by the Capital Employed figure. Then multiply this figure by 100 to get the percentage. This figure measures the firm’s ability to generate profits from the money invested in the business. It shows the return the investor will get for the money the give to the business. The higher the ROI the better

**ROI**  **Def** is the **net profit a business generates** from the **total finance used by the business (capital employed).** It measures the profitability of a business, compared with the money invested in it.

***Formula***: Net Profit 100

x

Capital Employed 1

**LIQUIDITY**

These ratios show the ability of a business to pays its short-term debts as they fall due. There are 2 ratios that you need to know here. There are

1. Current Ratio
2. Acid Test Ratio
3. *Current Ratio*

This is also known as the Working Capital Ratio. It is calculated by taking the Current Assets figure and dividing it by the Current Liability figure. The Ideal Ration here is to have 2:1. This means that for every 1 Liability we owe we have 2 Assets to pay for it or for every €1 we own we have €2 to pay. This means that we can repay our debts and still have money in the business.

***Formula***: Current Assets

Current Liabilities

1. *Acid Test Ratio*

This is also known as the Quick Ratio. It is calculated by taking the Current Assets less Closing Stock figure and dividing it by the Current Liability figure. The Ideal Ration here is to have 1:1. This means that for every 1 Liability we owe we have 1 Assets to pay for it or for every €1 we own we have €1 to pay. This means that we can repay our debts and still have closing stock left over to sell. If this ratio is disimproving from year to year it means the business is carrying too much stock in its current assets. This may result in a difficulty in raising cash to pay short term debts, as stock can take time to sell.

***Formula***: Current Assets – Closing Stock

Current Liabilities

*What does Liquidity Ratio Tell us about the business?*

1. Liquidity – This tells us about the firm’s ability to raise funds to repay it’s short term debts as they fall due. This is done by converting Current assets into cash. If liquidity is too low the business swill not be able to repay its debt on time and might go out of business
2. Insolvency – This occurs when the liabilities (Debt) is higher that the Assets. This means that the business scan not pay its debts back. Insolvency is very serious and can result in a business going into liquidation
3. Liquidation – This is when a business is closed, and their assets are sold off. The money raise from this is used to pay the creditors the money they are owed.

*How can a business manage its working capital?*

It is very important that all business manage their working capital so they can pay back their debts. To Help with this firms can do the following

1. Sell of slow-moving stock – this will result in the company getting cash
2. Proper stock control – This will reduce the amount of money that the company has tied up in stock and free up storage
3. Credit Control – Monitor which customers to give credit to and for how long. Effective credit control and reduce bad debts.
4. Increase prices – This will increase the profit margins
5. Raise more finance – This can be done by selling shares, getting a loan or selling off assets
6. Prepare Cashflow forecasts – This will help to identify money problems and to put in measure against it (get a Loan). It will also show the money going in and out of the business.

**GEARING**

This ratio shows the capital structure of the business and its ability to repay long term debts.

There are 3 different outcomes

1. Lowly Geared – This means that the ratio of debt to equity is less than 100% or 1:1. This will mean that the company will find it easier to pay dividends and reinvest profits as they don’t have to pay back a lot of interest on the debt that they have.
2. Neutral Geared - This is when a company has a debt/equity ratio of 100% or 1:1
3. Highly Geared – This means that the ratio of debt to equity is greater that 100% or 1:1. This means that the business has a high level of debt (Loans) compared to its equity. This will result in the business having to pay back a lot of interest of the borrowing they have. Which will result in less dividends for shareholders

***Formula***: Debt Capital

Equity Capital

Equity Capital – This is Ordinary Shares issued plus Retained earnings

Debt Capital – This means Preference Share plus Debentures.

**The debt/equity ratio** **Def** is an analysis of the capital structure of the business. It indicates what proportion of capital is made up of long term loans and what proportion of capital is made up of reserves and issued ordinary share capital.

*The effect of a highly geared company*

1. Greater pressure on Management – To increase profits to repay the interest
2. Reduced dividends – Payments of Preference share and debenture loans get paid before any ordinary shareholders
3. Difficulty raising finance – Less likely to pay dividends and therefore more risky
4. Difficulty raising loan finance – Bank will have doubts in the firm’s ability to pay back loans
5. Risk of Liquidation – It interest rate ore not paid on time or in full the business may be forced to close.

*The importance of the Debt/Equity Ratio in deciding on new sources of finance*

1. If the company is a lowly geared company which means the majority of the capital has been provided by the owners in the form of share capital and retained earnings. Raising finance through additional loans is an option because it does not have too many existing loans already, as it is lowly geared.
2. This will be the opposite for a highly geared company.

**WHY ARE STAKEHOLDERS INTERESTED IN MONITORING THE FINANCE OF A BUSINESS?**

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| **Stakeholder** | **Interest In….** |
| 1. Managers | 1. They want to know how well they are managing the business 2. How is the business performing to rivals? 3. Business ratios can help them with decision making |
| 1. Owners and Investors | 1. They will want to know the business ability to generate profits, pay dividends and long-term debt (Net Profit Percentage) 2. The ROI will tell investors if they are better putting the money in a bank 3. Debt/ equity tell investor how risky a business is |
| 1. Employees | 1. They will want to know if a business sis profitable and can pay back its debt. This will let them know it they will have a job in the future. |
| 1. Banks | 1. Bank are interest in the business ability to repay loans and if they have any assets as security. 2. They will also look at liquidity ratios |
| 1. Suppliers | 1. Suppliers are interest the firm’s ability to pay for goods that they supply 2. They will not sell on credit if there is a risk of non-payment |
| 1. Government | 1. They government will want to know the company’s profit, so they know they are paying the correct corporation tax 2. They will want to know if the grant has help the business grow |
| 1. Competitors | 1. They can identify the financial strengths and weakness and if the business is to expand or survive |

**LIMITATIONS OF RATIOS ANALYSIS**

Financial ratios do not consider the following:

1. Staff relations with Management not taken into account/the climate in business is difficult to assess.
2. **Assets may not be shown at their true value.**
3. Ratios are based on **past figures and not on projected future figures.**
4. Final Accounts only hold for a **certain year**/Balance Sheets are only true for the **day they are written.**
5. **Does not consider** business environment i.e. **competition/recession/outside influences**
6. **Inflation/deflation** may **impede the comparison** of ratios **from one period to another.**
7. **Different accounting policies may be used** from one year to the next.