Credit value: 10

5 Business accounting

In this unit, you will learn about how important money is to a business. Whether a sole trader or a large business, the owners and managers need to keep a close eye on their finances to ensure that enough money is coming in to cover and preferably exceed the amount of money going out.

Business accounting considers why it is so important for businesses to keep track of their finances to ensure their survival. In particular in this unit, you will learn about the flow of money in and out of the business and the importance of the timing of these cash flows. Imagine if you wanted to go out this Saturday but had no money – you may know that you will be getting paid in two weeks' time, but you would have a cash flow problem. The same can be true in business. You will learn how to draw up a cash flow forecast for a business and why this is important.

You will also learn how to draw up financial records for a business so that at the end of a year, a business can work out if it has made a profit or a loss, and also what the business is worth. Most people who are in business are interested in how much money they are making and try to find ways of increasing the amount of money made by controlling the cash coming into and going out of the business.

Often learners say that they do not like finance because it is like maths. This is not true. The numbers are straightforward and really it is about money!

Learning outcomes

After completing this unit, you should:

1. understand the purpose of accounting and the categorisation of business income and expenditure
2. be able to prepare a cash flow forecast
3. be able to prepare profit and loss accounts and balance sheets
4. be able to review business performance using simple ratio analysis.

Assessment and grading criteria

This table shows you what you must do in order to achieve a pass, merit or distinction grade, and where you can find activities in this book to help you.

To achieve a pass grade, the evidence must show that the learner is able to:	To achieve a merit grade, the evidence must show that, in addition to the pass criteria, the learner is able to:	To achieve a distinction grade, the evidence must show that, in addition to the pass and merit criteria, the learner is able to:
P1 describe the purpose of accounting for an organisation **See Assessment activity 5.1, page 181.**		
P2 explain the difference between capital and revenue items of expenditure and income **See Assessment activity 5.1, page 181.**		
P3 prepare a 12-month cash flow forecast to enable an organisation to manage its cash **See Assessment activity 5.2, page 188.**	**M1** analyse the cash flow problems a business might experience **See Assessment activity 5.2, page 188.**	**D1** justify actions a business might take when experiencing cash flow problems **See Assessment activity 5.2, page 188.**
P4 prepare a profit and loss account and balance sheet for a given organisation **See Assessment activity 5.3, page 196.**		
P5 perform ratio analysis to measure the profitability, liquidity and efficiency of a given organisation **See Assessment activity 5.4, page 201.**	**M2** analyse the performance of a business using suitable ratios **See Assessment activity 5.4, page 201.**	**D2** evaluate the financial performance and position of a business using ratio analysis **See Assessment activity 5.4, page 201.**

How you will be assessed

You will be asked to help a new entrepreneur to understand the basics of business accounting and to produce and explain a 12-month cash flow forecast to them. You will then revisit the entrepreneur after they have been trading for a year and produce their first set of financial documents – a profit and loss account and balance sheet. You will then be able to help the entrepreneur understand the good and possibly not-so-good points of their first year in business by carrying out and interpreting the results of ratio analysis.

Jade

I was quite worried about this unit as I have never been very good at maths, but actually I really enjoyed it. I soon realised that all the numbers were given to me and I just had to do straightforward calculations such as add, subtract, multiply and divide. In particular I enjoyed the ability to understand how a business calculates whether it has made a profit or a loss.

The first thing I did was make sure that I understood the terms that were being used. When I prepared my presentation I ensured that I had put any terms used into language that I understood. I pretended that I was talking to a real entrepreneur and that although they had a good business idea they needed help with understanding the money aspect of setting up and running their business.

When producing the documents, I tried to be very logical and tick numbers off as I used them so I knew I hadn't missed a number out. I also used a spreadsheet with formulae in it. I found this a little tricky to start with, but managed to get it set up with a bit of help. This was really useful because it meant every time I changed a number all the sums were done for me, so I didn't need to keep recalculating them. It also meant I was less likely to make mistakes.

The East End market trader

Mitch runs a second-hand CD and DVD stall on an East End market. He opens his stall three days a week and on Saturdays, his busiest day, he is helped out by his girlfriend Vicky. Mitch is trying to earn a bit of extra cash to pay for his van's MOT, which is due soon, and so has also started to offer his services as a delivery man to other local businesses or individuals.

Draw a table with two columns for money in and money out, for Mitch's delivery man service. In pairs, try to list as many things as you can think of under these two columns. Are there any costs (the money out), that Mitch would have to pay even if he had no customers?

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

It is impossible to truly understand how a business operates without some knowledge of the accounting process. You may be familiar with the expression 'a picture paints a thousand words' – in business we can adapt this to 'numbers paint a thousand words'. Anyone who wants to understand how well a business is performing – such as the owner, an **employee** or a potential investor – is likely to turn straight to its accounts. However good a business idea might be, if the owner does not keep a careful eye on the business's accounts, it is almost doomed to failure.

1.1 Purpose of accounting

Accounting involves the recording of **financial transactions**, planned or actual, and the use of these figures to produce financial information. In this first section we will look at a number of reasons why accounting is important to business success.

Record transactions

Keeping business records accurate and up to date is important for the smooth running of a business. Either the business owner or maybe a bookkeeper must record all of the money coming into the business (from sales) and all of the money going out, such as expenses. If a business fails to do this it may find itself not chasing payments, forgetting to pay bills or, even more seriously, in trouble with **HM Revenue and Customs** (HMRC). If the business does not record its transactions correctly, it cannot report its financial performance accurately and therefore tax payments may be wrong.

Did you know?

HMRC carries out counter evasion work to try to ensure that everyone is paying the tax they should. Incorrect tax payment may be a genuine error as a result of poor accounting or may be due to outright intention. The amount of money gleaned from reluctant taxpayers has risen from £1.13 billion in 1992 to £9.17 billion in 2007. HMRC reports that this money has come from a number of sources including individuals and companies. (Source: www.bbc.co.uk)

Key terms

Employee – a person who works for a business

Financial transaction – action by a business that involves money either going into or out of a business – for example, making a sale or paying a bill

HM Revenue and Customs – HM is an abbreviation for Her (or His) Majesty's, and the HMRC is a British government department responsible for the collection of all types of taxes

Monitor activity

Records will be updated on a regular (ideally daily) basis and therefore provide a good indication of how the business is doing in terms of sales, receiving payments, paying expenses and so on. The owner would soon realise if money going out seemed to be on the increase while sales were dropping off. Monitoring activity should also involve keeping an eye on the bank balance to ensure there are sufficient funds to meet day-to-day expenses.

Control

The ability to control the business's accounts is a direct result of the previous two purposes. If accurate records of transactions are maintained and activity closely monitored, then actions can be taken to control the balance between money flowing in and out of the business. For example, if it appeared that expenses were creeping up but sales staying the same, then the owner could look for ways to control or cut costs.

Management of the business

A manager is someone who is responsible for the planning, monitoring and controlling of the resources for which they are responsible. A manager who clearly understands the business's accounts will be better able to make informed decisions and plan for the future. Management of a business involves careful co-ordination of resources including staff, materials, stock and money. The manager must ensure there are sufficient funds to pay wages, order new stock, pay bills and meet other demands for cash outflows by balancing this with the money coming in from sales.

Measurement of financial performance

Without financial records it would be impossible to know if the business was making a **profit** or a **loss**, or whether or not the business was owed money or in debt to others.

Throughout this unit we will consider how a business can measure its financial performance and what actions it can take to improve its performance. Key indicators of financial performance include:

- **gross profit** – this is the amount of profit left after the cost of producing the good or service is deducted from the amount of **sales revenue**
- **net profit** – this is the smaller amount of profit made after all other expenses are deducted from the gross profit
- **value owed to the business** – this is the amount of money owed to the business from sales that have not yet been paid for
- **value owed by the business** – this is the amount of money the business owes to others for goods or services purchased but not yet paid for.

So, business accounting looks at money coming into and out of a business. We will now consider these two aspects of business accounts in more detail, which are:

- the money coming in (the income)
- the money going out (the expenditure).

1.2 Capital income

Capital income is the money invested by the owners or other investors that is used to set up a business or buy additional equipment. It tends to be used to buy things that will stay in the business for a medium-to-long period of time – for example, premises, vehicles or equipment. These are called **fixed assets**. When setting up a business, capital income might also be used to buy opening stock, but as the business develops, stock should be paid for by sales income. The sources of capital income available to business owners are influenced by the type of business.

Sole trader

A sole trader is a person who owns a business on their own; they therefore have to find all of the capital income from their own sources or personal loans. Sole traders often invest their personal savings into the business or borrow from the bank using their personal **assets**, such as their house, to secure the loan. This investment is a big risk for a sole trader, as they are ultimately responsible for the debts of the business. Being a sole trader can also limit the amount of money available and can therefore restrict the size of the business. However, if successful, the sole trader can keep all of the profits for themselves.

Key terms

Profit – surplus achieved when total revenue (income) from sales is higher than the total costs of a business

Loss – shortfall suffered when total revenue from sales is lower than the total costs of a business

Gross profit – sales revenue minus cost of goods sold (the cost of the actual materials used to produce the quantity of goods sold)

Sales revenue – quantity sold times selling price

Net profit – gross profit minus other expenses – for example, rent and advertising

Capital income – money invested into the business either to set it up or buy equipment

Fixed assets – items of value owned by a business that are likely to stay in the business for more than one year – for example, machinery

Asset – something that is owned by a business or individual

Partnership

A partnership is when two or more people join together to set up a business as partners. Each partner would be expected to contribute towards the capital income, hence increasing the potential amount of money available. Partners also share decision making and the profit. In most partnerships, any loans taken out are still secured by the partners' own assets, so this is still a quite high-risk option.

Shares

A company is when a business is registered with Companies House and issues shares to its shareholders (see Unit 1, page XXX for more details). The shareholders are the owners of the business and all contribute towards the capital income. Shareholders normally receive a voting right and the more shares they own, the greater their ability is to influence decision making. Shareholders are rewarded for their investment by the payment of a dividend; this is a share of the profits.

Loans

A loan is an amount of money lent to the business or business owner(s) from a bank. It is a lump sum that then has to be paid back at a set amount per month over the period of the loan, often five years, although longer-term loans can be agreed. As well as the repayment of the loan, there will be a monthly interest repayment. This is the amount of money the bank is charging for the loan as a percentage of the amount borrowed. The **interest rate** can be fixed or it may vary with changes in the economy. It is the interest payable on top of the loan that makes a loan a relatively expensive source of capital income. Monthly payments have to be made even if the business is not making a profit.

Key term

Interest rate – the percentage rate a bank charges for a loan, that is, the cost of borrowing money

A bank loan can be crucial to the survival of a new business.

Buying a property is a big investment for a business.

Banks are not guaranteed to lend money to a business, so the business would have to justify how the money borrowed would be spent and, more importantly, how they can afford to repay it. Often bank loans have to be secured against an asset (for example, the entrepreneur's home or the company's vehicles) to convince the bank that the risk being taken is not too great. This means if the business fails to meet payments, the bank can reclaim the asset.

Mortgages

A mortgage is similar to a bank loan, but it tends to be for a larger sum of money and over a longer period of time (typically 25 years). Mortgages are always secured on an asset, normally a property. Individuals will take out a mortgage to buy a house. Businesses might take out a mortgage to buy their premises – for example, a factory, retail store or warehouse.

1.3 Revenue income

As we have already seen, capital income is the money invested in the business to set it up or later buy additional assets; it is a long-term investment. Revenue income is the money that comes into the business from performing its day-to-day function – selling goods or providing a service. The nature of the revenue income depends on the activities that the business does to bring in money, and three main sources are:

- sales
- rent received
- commission received.

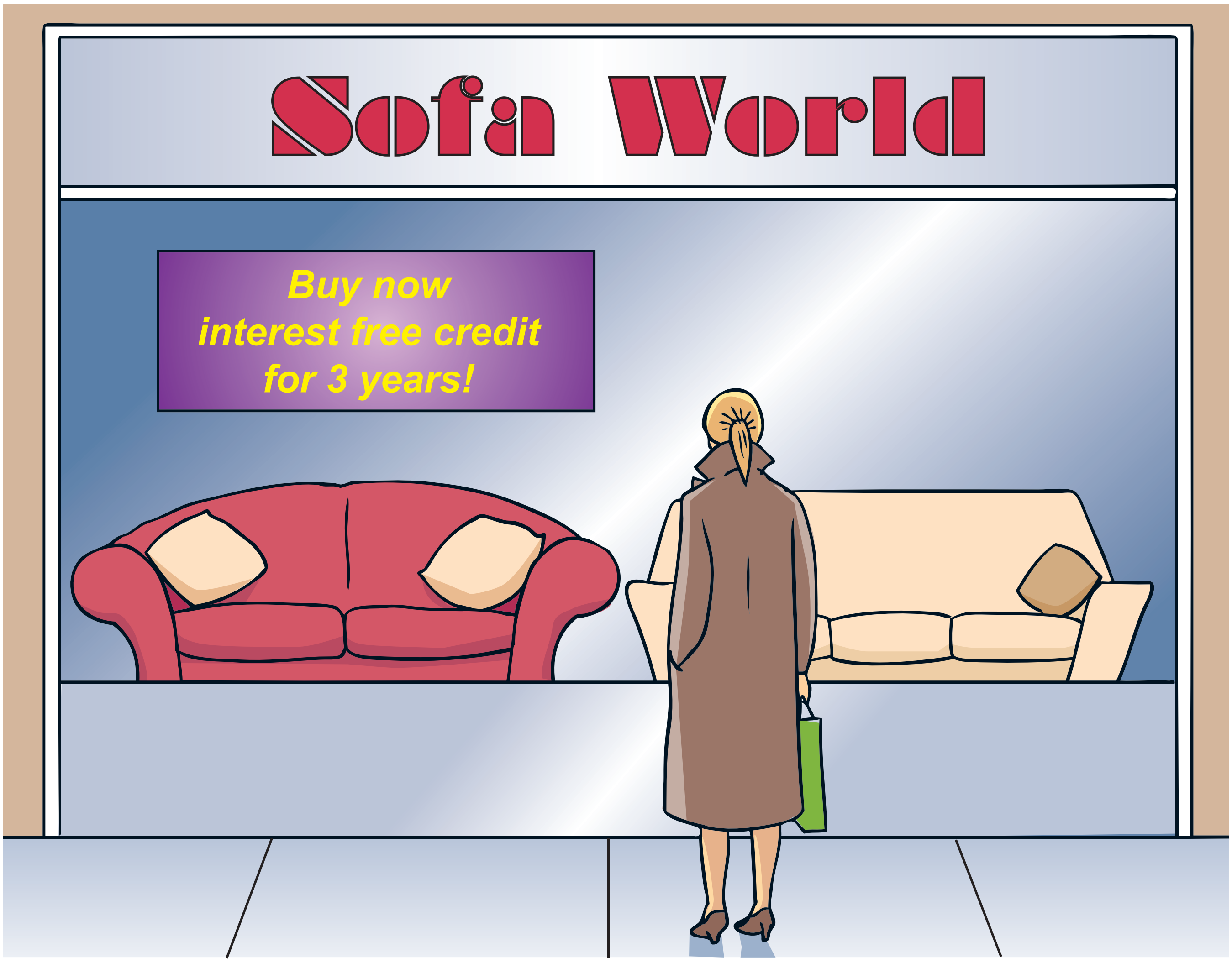


Fig. 5.1: What are credit sales?

Sales

Sales, or sales turnover, is money coming in from the sales of goods or services. For example, a jeans shop has money coming in each time a customer buys a pair of jeans, or a hairdresser each time a customer has a haircut. Sales turnover is therefore determined by the prices charged and the number of customers.

Sales can be either cash sales (the customer pays there and then), or credit sales (the customer buys then but pays at a later date). The significance of the difference between cash and credit sales will become clear later on when you learn about cash flow.

Rent received

A business that owns property and charges others for use of all or part of that property will receive rent as their main source of income. If a business owns a house and rents out three rooms to students, then it will receive rent from each of these students. Similarly a business may own land or offices which it rents out to other businesses.

Commission received

A business may sell products or services as an agent of another business. They sell another business's products on their behalf and for each sale they make, they get paid a percentage on that sale. This percentage is called **commission**. If, for example, you were to buy tickets for a concert from www.ticketmaster.co.uk, then Ticketmaster would receive a percentage payment for that ticket from whichever company was hosting the concert.

Key term

Commission – a percentage paid on a sale to the person or business responsible for making that sale

WorkSpace

Christian

Sales Ledger Clerk

Christian has worked for eight months as a sales ledger clerk at Vamous Vehicles, a small independent courier business. The business operates a fleet of four delivery vans providing next-day courier services to and from anywhere in the UK.

What does your job involve on a daily basis?

I am responsible for keeping the sales ledger up to date. This is a record of all of the sales made by the business and of the payments received from customers. In effect, it lets the boss know how much is being made in sales and how much money is still owed. On a daily basis this means I have to:

- collect job sheets from drivers for the previous day's deliveries
- issue invoices to customers requesting payment for the delivery made
- check the post for incoming money received
- check the bank account online for incoming money received.

I have to input all the details accurately on to the computer. At the end of each week, I check through all the invoices that have not yet been paid. We allow our customers 30 days to pay, so if the invoice was issued more than 30 days ago and has not yet been paid, I have to chase the customer. Most of the time they apologise and say they will authorise payment there and then. If, however, I think there might be a problem, I have to tell my manager.

Do you also deal with the money going out of the business?

No, that is Tanya's job – she is the Purchase Ledger Clerk. She has to record all the purchases made by the business and authorise payment for these. For example, all our drivers have a petrol card for BP service stations. So each month Tanya will authorise the bank to pay the month's fuel costs to BP.

Why is your job important to the business?

If I don't issue an invoice and chase payment, then we would be providing a service for free! The invoice asks the customer to pay and is the first step towards getting cash into the business. If there is not enough money coming in, even if sales are being made, then the business might have cash flow problems and be unable to make payments. I for one wouldn't be very happy if my wages didn't get paid at the end of the month!

Think about it!

1. Why is it important that Christian records all sales accurately?
2. Why should Christian tell his boss if he thinks there might be a problem with a customer paying?
3. What actions might a business take if a customer does not pay the invoice on time?
4. What are the benefits to the firm of drivers having petrol cards?
5. Explain why, if Christian fails to do his job properly, the business may have cash flow problems.

1.4 Capital expenditure

Expenditure is money spent by a business and can be split into two categories: capital expenditure and revenue expenditure. We are going to start by looking at capital expenditure. This is used to buy **capital items**, which are assets that will stay in the business for a long period of time. Capital items are fixed assets and intangible assets, as explained below.

Fixed assets

Fixed assets are items owned by a business that will remain in the business for a reasonable period of time. These are shown on a business's balance sheet and include land and buildings, office equipment, machinery, furniture and fittings, and motor vehicles. These are sometimes referred to as 'tangible assets' because they can be touched.

Most fixed assets lose value over time and for this reason they are depreciated. This means that each year their value in the balance sheet is reduced in order to give a fair value of the asset.

Intangibles

An intangible asset is something owned by the business, that cannot be touched but adds value to the business. Here are three common intangibles that exist within businesses.

- **Goodwill** – when you buy an existing business, its name and reputation will already be known, and it may already have an established customer base or set of clients. This increases the value of the business and therefore increases the selling price of the business. A sum of money is added to the value of the business to reflect the value of this goodwill. However, goodwill is difficult to place a figure on – how much would you pay for a recognised brand name?
- **Patents** – a patent is the legal protection of an invention, such as a unique feature of a product or a new process. An entrepreneur or business may patent their idea to stop others from copying the idea. Having a patent allows the business to exploit this in the future by launching an innovative product at a premium (more expensive) selling price. The patent itself must therefore be worth something, but again it is difficult to know exactly how much value to place on it.

Key term

Capital items – assets bought from capital expenditure such as machinery and vehicles

- **Trademarks** – a trademark is a symbol, logo, brand name, words or even colour that sets apart one business's goods or services from those of its competitors. Trademarks can be a key influence on consumer choice and build a strong brand loyalty. A trademark therefore is of value to a business and consequently recorded as an intangible asset.

How do you decide upon the monetary value of a trademark?

1.5 Revenue expenditure

Revenue expenditure is spending on items on a day-to-day or regular basis. These are the expenses incurred by a business that are shown on the profit and loss account. The types of costs incurred vary from business to business, but some of the more common types include:

- premises costs
- administrative costs
- staff costs
- selling and distribution costs
- finance costs
- purchase of stock.

Case study: Colour wars

What do you associate with the colour orange?

When Stelios Haji-Ioannou, founder of easyJet, launched easyMobile in 2004 it was no surprise he planned to use his recognised colour – orange. However, competitors Orange, an established mobile phone company, were less than happy, claiming they were first in the mobile phone market and were recognised for the colour that goes with their name.

Orange, the company, claimed that a rival in the market using the same colour would cause confusion to customers and wanted to stop Stelios from using the colour. Orange had trademarked a specific shade of orange, but Stelios was not going to give up the fight easily, saying, 'I'm quite happy to see them in court. I don't believe they have a case.'

Other trademarks include Heinz's distinctive turquoise cans, Cadbury's famous shade of purple and Toblerone's triangular box.

1. Should Orange be able to stop a competitor from using a specific colour? Justify your answer.
2. Why might it be important to show a value for these trademarks in a business's accounts?
3. How would you go about attaching a monetary value to these trademarks?

Source: adapted from www.bbc.co.uk

Premises costs

All businesses will have some sort of premises costs, from renting a market stall or using a room in the entrepreneur's home to renting factories or large retail stores. There are a number of costs associated with premises.

- **Rent** – the business may not own the premises and may therefore have to pay a regular sum of money for its use of the premises.
- **Rates** – in the same way as private residents pay council tax to the local authority, businesses pay non-domestic rates. This is a sum of money paid to the local council to go towards services such as street lights and refuse collection. This is not a set amount, but is calculated by the council based on the size and location of the premises, and the nature of the business.
- **Heating and lighting** – this covers payments for services such as gas and electricity. The business will receive regular bills, often quarterly (every three months) for the provision and use of these services.
- **Insurance** – a business is legally required to take out a number of types of insurance to protect itself from the possibility of serious losses. These include:
    - buildings insurance – to protect the physical building from damage that may be caused by events such as fire
    - contents insurance – to protect what is inside the building in terms of machinery, fixtures and fittings and stock from damage that may be caused by events such as flooding
    - public liability insurance – to protect people within the building who may be harmed or injured from an event such as an accident.

Administrative costs

Administration refers to the paperwork that goes on within a business either internally between employees or externally with suppliers and customers. Administrative costs include items such as postage, printing and stationery, which might include items such as business cards, headed paper and order books.

Telephone charges are also classed as an administrative cost and are slightly unusual from an accounting point of view. For a land line these costs are split into two; there is the line rental cost, which is paid quarterly in advance and then the call charges, which are paid quarterly after use.

Staff costs

Most businesses will employ staff. A common misunderstanding by business studies learners is that a sole trader has to do everything themselves. This is not true – they own the business by themselves, but can employ as many people as they want, need or can afford!

A larger business may try to reduce staff costs by using more machinery. A firm with a high number of staff to machines is called 'labour intensive'; one with a greater emphasis on machines is called 'capital intensive'.

Staff costs can include the following.

- **Salaries** – a salary is an annual figure paid to an employee divided into equal monthly payments. For example, a trainee accountant may have a salary of £18,000 per year, meaning their gross pay is £1,500 per month. The employee will then have to pay National Insurance, tax and maybe pension contributions on this figure, so the amount they actually take home will be quite a bit less. For the business, however, the actual amount they have to pay (the real cost to the business) is higher. On a salary of £18,000 the business also has to pay **employers**' National Insurance of 12.8 per cent, an additional £2,304 plus any pension and additional benefits.
- **Wages** – a wage is an hourly rate paid to an employee, meaning there is a direct link between the number of hours worked and the amount of money paid. Paying a wage rather than a salary allows greater flexibility for both the employer and the employee, but also creates greater uncertainty.
- **Training** – a business may want to train its employees in order to help get the most out of them. Training means that employees are better able to do their job and this should ultimately lead to a better business. However, training is expensive – especially if employees are sent on courses away from the business such as external training days, have day release at college or are supported through professional qualifications. In terms of both internal and external training, the cost is not only the financial cost in terms of paying for the training, but also the loss of time while the worker is not carrying out their job.
- **Insurance** – a business is responsible for its employees while carrying out any duties related to their work and therefore the business has to take out employers' liability insurance. This means that if the employee is injured at work, the business is protected against any claims for compensation or any legal costs incurred.
- **Pensions** – some businesses offer a pension scheme as an added bonus for employees. Both parties will contribute towards the pension fund on a regular basis. Offering a pension scheme adds to the costs of the employer. There may also be an additional cost as the business will have to pay someone to administer the fund.

Key term

Employer – a business that employs workers

Selling and distribution costs

If a business is to survive, it must make enough sales to cover all of its costs. It must be able to attract customers and get the product or service to the customer. These two crucial functions carry additional costs. Selling and distribution costs include:

- **sales staff salaries** – many businesses will employ workers with specific responsibility for sales. This

Activity: Minimum wage

Employers in the UK, by law, have to pay a minimum wage to all employees over the age of 16. When the minimum wage was first introduced in the UK in 1999, it was £3.60 per hour for employees over 22. The initial introduction of the minimum wage and each subsequent rise causes wage costs of businesses to go up.

Do you know what the minimum wage rates are today for:

- 16–17-year-olds
- 18–21-year-olds
- 22-year-olds and over?

1. Write down what you think the minimum wage is for each age group.
2. Use the Internet to check whether you are correct.
3. Carry out some research to find out how the minimum wage has changed since its original introduction.
4. Plot this information on a graph.

Fig. 5.2: What are the advantages to a firm of using a commission pay scheme for sales staff?

might be a sales representative who travels around trying to generate sales, sales assistants who help the customer, or accounts managers who look after regular customers, ensuring they keep making repeat orders. Regardless of the type of salesperson, they will require paying. Often sales staff receive a commission-based salary, meaning the more they sell, the more they can earn

- **carriage of sales** – this is the cost of getting the sale to the customer and can range from something as simple as an envelope and stamp or courier delivery to something much more complex with bulky or fragile products or even products being shipped to another country. Some businesses try to pass this cost on to the customer by quoting a sales price plus postage and packaging cost
- **marketing** – this covers a whole range of costs associated with attracting the customer and convincing them to make a purchase. Possible marketing costs might include advertisements, promotional literature, promotional events, point of sale materials, and so on.

Finance costs

Most businesses do not operate on a cash-only basis – they are likely to accept payments by cheque, card or direct bank transfer. They are likely to make payments in the same ways. This means that the business needs a bank account. Banks are also businesses and they too want to make a profit; they therefore charge for their services. Finance costs to a business can include:

- **bank charges** – unlike personal banking, which is generally free, banks charge businesses for each transaction that takes place, for example, every time a cheque is paid in or written, whenever cash is deposited, and so on. Banks might offer free banking to businesses for the first year as a marketing technique, but once the first year is over, bank charges can soon start to add up to quite a large amount of money
- **loan and mortgage interest** – if the business has a bank loan or a mortgage, then interest will be charged on this. Banks may offer big businesses preferential rates if they are confident that the money will be paid back and if they want to keep that particular business as a loyal customer. Big businesses will carry out a lot of transactions and pay high bank charges, so for the bank it may be worth offering lower interest rates to keep them happy.

Purchase of stock

Most businesses providing a good or service will require some sort of stock, whether it is raw materials, finished goods to sell on or supplies to provide the service – for example, shampoo and conditioner for a hairdresser. When a business is first set up, it is likely to have to buy stock with cash as it will not have built a reputation as being trustworthy and able to pay. As a business becomes more established, it may be able to buy stock on credit (such as receiving the stock and paying 30 days later). Bigger and more established businesses may also be able to drive the cost of stock down as they will buy in larger quantities. There are other costs related to stock, such as insurance and storage costs.

How can business drive stock-related costs down?

Assessment activity 5.1

P1 P2

BTEC

Engaging Enterprise is a local organisation that promotes enterprise in young people and offers support and help to new entrepreneurs. It has recently launched a new scheme called Acorn, a 12-week programme aimed at encouraging and helping 16–25-year-olds to set up in business.

You have been invited along as a guest speaker to give a presentation on the purpose of accounting. Your presentation should address the following questions.

- Why is it important to keep accurate financial records?
- How will these records help the entrepreneur?
- What is meant by revenue and expenditure?
- What is the difference between revenue expenditure and capital expenditure?
- What types of revenue and capital expenditure can they expect to incur?
- What is the difference between revenue income and capital income?
- What types of revenue and capital income can they expect to incur?

1. Describe the purpose of accounts. P1
2. Explain the difference between capital and revenue items of expenditure and income. P2

Grading tips

1. 'Purpose' means why something is important and how it will help. In this section of your presentation try to focus on:
   - why an entrepreneur would have to keep accurate financial records
   - how this would help them in setting up and running a business.

   You must include why it is important to have historical data to be able to check on financial performance and position, as well as the planning aspect of accounting. Remember that whenever you use technical language, it is important you explain it in your own words. P1
2. To effectively explain the differences between capital and revenue items of expenditure and income, you need to cover the following categorisations:
   - capital income
   - revenue income
   - capital expenditure
   - revenue expenditure.

   You should make sure you give a clear definition of each term and support with examples appropriate to new entrepreneurs. At this stage you are not expected to calculate profit or to know the impact of the income and expenditure items on profit. P2

2. Prepare a cash flow forecast

Cash flows into and out of a business on a regular basis. A **cash flow forecast** tries to predict in advance what and when these cash flows will be. Having a healthy cash flow is crucial to the survival of a business. A healthy cash flow means that a business will have enough cash at any one point in time to be able to meet demand for short-term cash outflows. Imagine what would happen if at the end of the week a manager turned to the business's employees and said, 'Sorry, I haven't got enough cash to pay your wages this week.'

By forecasting cash flow in advance, a business can identify where there might be shortages and either try to prevent this from happening or put plans in place to deal with it.

2.1 Cash flow forecast

Structure

A cash flow forecast is a simple statement showing opening balance, cash in, cash out and closing balance. It is normally shown on a monthly basis and drawn up for a 12-month period. The **opening balance** is how much money the business has at the start of the month and the **closing balance** how much money it has at the end of the month. For example, the closing balance at the end of January becomes the opening balance at the start of February.

Carla's Web has £1,000 available at the start of the year; Carla then predicts sales of £1,000 in January, £2,800 in February and £2,000 in March. In this case, total inflows and sales are the same, showing that Carla only makes cash sales and not credit sales.

The total cash available is opening balance plus total inflows. Carla predicts that her purchases will be £980

Key terms

Cash flow forecast – document that shows the predicted flow of cash into and out of a business over a given period of time, normally 12 months

Opening balance – amount of cash available in a business at the start of a set time period, for example, a month

Closing balance – amount of cash available in a business at the end of a set time period, for example, a month

Opening balance how much is available at the start of the year

	January (£)	February (£)	March (£)
Opening balance (b/f)	1,000	(280)	240
Income			
Sales	1,000	2,800	2,000
Total inflows	1,000	2,800	2,000
Total cash available	2,000	2,520	2,240
Expenses			
Puchases	980	980	500
Wages	1,000	1,000	1,000
Heat and light	300	300	300
Total outflows	2,280	2,280	1,800
Closing balance (c/f)	(280)	240	440

February's closing balance becomes March's opening balance

Cash available = Opening balance + Total inflows £1,000 + £1,000 = £2,000

Closing balance total cash available – total outflows £2,000 – £2,280 = (£280)

Brackets are used to show that a figure is negative

Fig. 5.3: Cash flow forecast for Carla's Web design business.

in both January and February, and £500 in March, while wages will be £1,000 per month and heating and lighting £300 per month. Total outflows are all of Carla's expenses added together. The closing balance is calculated by deducting the total outflows from the cash available. Remember that one month's closing balance becomes the next month's opening balance.

Activity: Personal cash flow

Draw a cash flow table to show your personal finances for the next month. You should think about what money will be coming in from wages, EMA (Education Maintenance Allowance), presents, parents and so on as appropriate, and also what expenses you will have. These might include food and drink, presents, trips, travel and so on.

1. What is your opening balance at the start of the month?
2. What is your closing balance at the end of the month?
3. Are there any points during the month where you may have a cash flow problem?
4. What actions can you take to ensure that any cash flow problems are solved?

Timescale

The timing of the cash inflows and outflows is important. In the above example, at the end of three months Carla has a positive balance of £440, but in January she had a negative balance of £280. This means that although her cash flow was healthy at the end of three months, she had problems earlier and would have had an **overdraft** of £280 in her bank or been unable to pay one of her expenses, which could stop her from operating successfully in the following months.

Credit periods

Credit periods have two major influences on a business's cash flow.

1. The business must consider how long it gives its customers to pay. If it accepts cash sales only, then this will not be a concern, but it may have to offer credit in order to ensure a sale. The longer the credit period, the slower the money coming in. If a greengrocer gives one month's credit for a sale made in January, they will not see cash flowing into the business until February. Yet the greengrocer may have had to pay for its stock up front.
2. Credit periods affect the ability of the business to gain credit from its suppliers. If a business can secure supplies on credit, then this will slow down the flow of cash out of a business. The longer the credit period, the later the cash flows out. Some businesses can secure credit periods of 30, 60 or even 90 days.

If a business both sells on credit to its customers and buys on credit from its suppliers, it wants the first to have a shorter credit period than the second.

Receipts

Receipts are the money coming into the business from various sources, which include:

- capital from the owner(s)
- bank loan or mortgage
- cash sales
- credit sales – these customers are classed as **debtors** as they owe the business money
- rent
- commission
- other income – this could be, for example, a one-off cash inflow from the sale of an asset, such as a machine that is no longer needed.

Payments

Payments are the money going out of the business for various purposes, which include:

- buying capital equipment (capital expenditure)
- purchases of stock
- cash purchases (revenue expenditure)
- credit purchases – these suppliers are classed as trade **creditors**, because they have supplied goods or services on credit

Key terms

Overdraft – when more money is taken out of a bank account than is in it, making the account overdrawn

Credit period – length of time given to a customer to pay for goods or services received

Debtors – customers who have purchased goods or services on credit, meaning they are in debt to the business as they owe it money

Creditors – suppliers who have provided goods or services to a business on credit, meaning the business owes them money

- staff costs, premises costs, administrative costs, selling and distribution costs (revenue expenditure)
- loan repayments, with interest
- interest on an overdraft
- value added tax (VAT) – businesses that are VAT registered must pay VAT to HM Revenue and Customs (HMRC), and this should be shown in the cash flow forecast.

A business with sales in excess of the VAT threshold, £67,000 per year in 2009, must register itself with HMRC and then record VAT received on sales and paid on purchases. A business must then work out whether it has paid or received more money in VAT, then claim a refund or make a payment as appropriate.

If a company makes a sale of £100 plus VAT, then the cost of the sale to the customer will be £117.50. In the cash flow, the company will record a sale of £100 and VAT received of £17.50.

The same company may make purchases of £50 plus VAT. The purchases therefore cost the business £58.75. In the cash flow forecast, the company will record purchases of £50 and VAT paid of £8.75.

Did you know?

The standard rate of VAT in the UK is 17.5 per cent, although from the first of December 2008, the Chancellor Alistair Darling reduced it to 15 per cent for one year.

1. Why do you think the Chancellor made this decision?
2. What would this have meant for businesses?

At the end of each quarter, the company will add up all the VAT received and deduct from this all of the VAT paid. If the amount received is higher than the amount paid, then the company must pay HMRC the difference. If the amount paid is higher than the amount received, then the company can reclaim the difference.

Opening and closing cash/bank balances

The opening balance at the start of the year will be a true reflection of the business's bank balance, whereas the closing balance will be based upon the predicted

Case study: Paddington Games

Paddington Games sells £10,000 of games per month and purchases supplies of £6,000.

Table 5.1: Cash in for Paddington Games.

Cash in	Jan	Feb	March
Sales	£10,000	£10,000	£10,000
VAT on sales	£1,750	£1,750	£1,750
Refund from HMRC			
Total cash in	£11,750	£11,750	£11,750

Table 5.2: Cash out for Paddington Games.

Cash out	Jan	Feb	March
Purchases	£6,000	£6,000	£6,000
VAT paid	£1,050	£1,050	£1,050
Payment to HMRC			£2,100
Total cash out	£7,050	£7,050	£9,150

Over the three months January to March, the total VAT received was (£1,750 × 3) £5,250 and the total VAT paid was (£1,050 × 3) £3,150. The net VAT is therefore £5,250 – £3,150 = £2,100, meaning the business has received more in VAT than it has paid and therefore must make a payment of £2,100 to HMRC.

incomes and expenditures over the period of the cash flow forecast, normally a year. One of the key purposes of the cash flow forecast is to highlight in advance any months where there is a risk of a negative cash flow, as this allows the business to make arrangements – for example, a prearranged overdraft with the bank – or to try to take actions to avoid this.

A business with a negative closing balance is often said to have **liquidity** problems and is in danger of becoming **insolvent**. In the next section on cash flow management, we will look in more detail at methods available to try to avoid these negative closing balances.

Remember

The closing balance at the end of one month must be the same as the opening balance at the start of the next month.

Key terms

Liquidity – measure of a firm's ability to meet short-term cash payments

Insolvent – when a firm is unable to meet short-term cash payments

Case study: Lily's cleaning services

Lily is setting up a small business providing cleaning services to offices on a trading estate in Scarborough. She has asked you to help her prepare a cash flow forecast for her first 12 months of trading.

You should produce a forecast from January to December based on the information provided below:

Sales and purchases for the 12 months are expected to be as follows.

Month	Sales	Purchases
January	£5,000	£600
February	£5,000	£600
March	£5,000	£600
April	£5,000	£600
May	£5,000	£600
June	£5,000	£600
July	£4,000	£500
August	£4,000	£500
September	£5,000	£600
October	£6,000	£650
November	£6,000	£650
December	£6,000	£650

At the beginning of January she will buy two small cars, to drive herself and staff to the offices, each costing £10,000. She will invest £15,000 of her own money and has agreed a bank loan of £7,000. Lily will receive the loan in January and start repayments the following month at a fixed rate of £250 per month. When meeting with her bank manager, she also agreed a business overdraft that will be charged at a rate of one per cent on any negative closing balances.

In order to start trading in January, she buys £4,000 worth of cleaning equipment, including vacuum cleaners and floor buffers. In addition, she spends £150 on less durable (long-lasting) products such as dusters and mops, which she plans to replace every second month.

Lily plans to offer 30 days' credit terms to two of her bigger cleaning contracts. These two combined will account for £2,200 of her monthly sales.

Lily has rented a small lock-up to store her equipment and materials in at a cost of £600 per month. She will employ four cleaners each earning £400 per month and a cleaning supervisor earning an annual salary of £7,200. She will withdraw £1,000 a month for herself, and hopes to be able to increase this to £1,200 per month after six months.

Additional monthly costs include:

- £300 car insurance
- £20 advertising
- £100 fuel.

1. Use a spreadsheet to produce a 12-month cash flow forecast for Lily.
2. Identify and explain any potential cash flow problems she may face.
3. Do you think Lily was right to offer her two biggest customers 30 days' credit? Justify your answer.

PLTS

Creative thinkers

When analysing the possible cash flow problems, you will need to examine the reasons for these problems and then be able to identify and justify solutions.

Functional skills

Use ICT systems

If you produce your cash flow forecast using a spreadsheet package, this will demonstrate your ability to select and use ICT systems independently for a complex task.

Mathematics

Throughout this assessment activity, you will be using numerical data to produce and interpret financial information. It is important you use appropriate checking procedures to ensure your cash flow forecast is accurate.

2.2 Cash flow management

A cash flow forecast can help to identify where there are potential shortfalls but might also indicate where there are large amounts of cash left at the end of a month or year. Although you may think this is a good thing, if the cash balance at the end of each month is high, it might be an indication that the business is not taking advantage of opportunities. For example, could it use this cash surplus to improve or expand the business?

Cash flow forecasts are just that, a forecast, and therefore the actual cash flow of the business should be monitored alongside the forecast to see if inflows and outflows are as expected, better or worse.

Problems within the cash flow forecast

Problems occur with cash flows when the business's outflows are greater than the opening balance plus the inflows, as this will result in a negative closing balance. This means that the business will not have enough cash to meet payments that are due.

Very few businesses have consistent cash flows throughout the year; they are likely to experience busy times and quiet times. These fluctuations are known as the cash flow cycle. For some businesses, particularly those in a seasonal industry, these fluctuations can be quite severe. Someone who owns a small bed and breakfast in a seaside town will have to pay costs like rent, heat and light, insurance and bank charges throughout the year. In season, they will also have additional costs like wages and stock, but it might only be in these summer months where there are any cash inflows.

Solutions to cash flow problems

If a business has predicted cash flow problems in advance, then there are a number of possible solutions. These include:

- **overdraft arrangements** – a business with a fluctuating cash flow cycle should be able to show the forecast to the bank and make arrangements for periods of negative cash flows. Banks sometimes offer free overdraft facilities to help businesses through these periods, but only if pre-agreed. Going overdrawn on a bank account without an agreement with the bank can be a very expensive option
- **negotiating terms with creditors** – creditors are people or businesses that a business owes money to, normally because goods or services have been bought on credit as opposed to cash purchases. A business with cash flow problems could try to negotiate a longer payment term with its suppliers – for example, an increase from 30 days to 60 days. This would slow down the flow of cash out of the business. A negative effect of this, however, may be the loss of any discounts offered for prompt or early payment
- **reviewing and rescheduling capital expenditure** – having identified cash flow problems, the owner or manager could review what cash outflows were being spent on. Such a review might identify areas of expenditure that could be cut or postponed. It is difficult to do this if the expenditure is on revenue items – for example, replacement stock – but more achievable if it is capital expenditure. A business could, for example, postpone plans to replace machinery or buy a new van.

An alternative action here could be to consider leasing an item of capital equipment rather than buying it outright. This can prove expensive in the long run, but means that rather than paying one lump sum, the business can pay to use it on a monthly basis.

Case study: Lily one year on

Business is doing well and Lily is now going to prepare a cash flow forecast for her second year of trading. She has won two new contracts, each with 60 days' credit, that will boost her sales by 20 per cent. The knock-on effect of this is that her purchases will go up by 15 per cent, she will employ one new cleaner and replace her semi-durable equipment (the dusters and mops) every month rather than every second month.

Lily's business advisor has done a quick mental calculation and has told her that this means she will now have to become VAT registered.

1. Is the business advisor correct? Use calculations to justify your answer.
2. Create a cash flow forecast for Lily for her second year of trading. You do not need to start from scratch – save your last spreadsheet as year two and then make the necessary changes, assuming all other costs stay the same.
3. Comment on any cash flow problems Lily may face in year two.
4. Recommend the actions Lily could take to solve these potential cash flow problems.
5. Test your recommended solutions by making these changes to your spreadsheet and see what happens.

	January £	February £	March £	April £	Total £
Opening balance (b/f)	0	(3,500)	(1,520)	2,500	
Income owner's capital	10,000				10,000
Bank loan	15,000				15,000
Cash sales	5,000	7,000	8,000	7,000	27,000
Credit sales	0	9,000	11,000	12,000	32,000
Commission received	0	800	950	950	2,700
Total inflows	30,000	16,800	19,950	19,950	86,700
Total cash available	30,000	13,300	18,430	22,450	
Expenses					
Cash purchases	8,000	9,500	9,500	3,500	30,500
Credit purchases	0	0	0	7,000	7,000
Heat and light	0	0	0	200	200
Fixtures and fittings	5,000	600	0	0	5,600
Equipment	5,000	0	0	0	5,000
Drawings	0	2,000	2,000	2,000	6,000
Marketing	3,000	0	1,200	0	4,200
Premises costs	10,000	0	0	0	10,000
Insurance	500	0	0	0	500
Wages	1,000	1,500	2,000	2,000	6,500
Administrative costs	1,000	750	800	1,250	3,800
Overdraft interest	0	70	30	0	100
Loan repayments	0	400	400	400	1,200
Total outflows	33,500	14,820	15,930	16,350	80,600
Closing balance (c/f)	(3,500)	(1,520)	2,500	6,100	

Fig. 5.4: Sample cash flow forecast for the first four months of a sole trader.

Assessment activity 5.2

P3 M1 D1 BTEC

Sharma and Ryan were both 21 when they attended the Acorn programme run by Engaging Enterprise. They were keen to learn and have since decided to act upon the advice given during the 12 weeks and to set up in business together. They have decided on a new business called SIGNature Ltd. The business will manufacture plastic road signs for builders, tourist attractions and local councils.

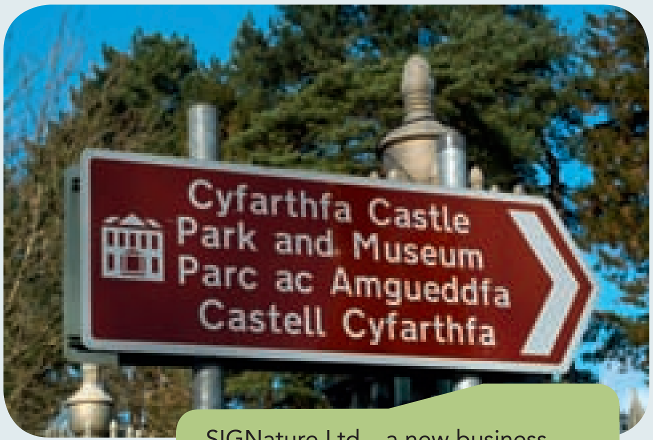
Sharma and Ryan have carried out substantial research into potential sales volumes, set-up costs and revenue expenses. They have approached you to help them set up and understand their first cash flow forecast. It is important that they get this right as it will form part of the business plan they are preparing to take to the bank manager in order to try to secure a loan.

1. You are to prepare a 12-month cash flow forecast for Sharma and Ryan based on the information presented below. Sales and purchases for the 12 months are predicted to be as follows.

Month	Sales	Purchases
January	£30,000	£13,500
February	£30,000	£13,500
March	£30,000	£13,500
April	£37,000	£16,650
May	£37,000	£16,650
June	£37,000	£16,650
July	£41,500	£18,675
August	£41,500	£18,675
September	£41,500	£18,675
October	£25,000	£11,250
November	£25,000	£11,250
December	£25,000	£11,250

These sales and purchases figures are before VAT has been added. VAT should be added at the current UK rate and shown in separate rows for VAT received on sales and paid on purchases. Every three months a figure should be shown to either make payments to HMRC for VAT owed or reclaim VAT if an excess has been paid.

Sharma and Ryan are the only two shareholders, each investing £12,500 of their own money into the business. In addition to this they secured a bank loan for £80,000 to be paid back in monthly instalments of £1,000. All of the capital invested was to be used to buy capital equipment to the value of £105,000. This was broken down into machinery worth £85,000 and fixtures and fittings worth £20,000. Sharma and Ryan had also agreed with their bank manager that they would be allowed an overdraft of up to £20,000 at a charge of 1.5 per cent per month whenever their account was overdrawn.



SIGNature Ltd – a new business manufacturing plastic road signs.

They planned to rent a small factory unit at a cost of £25,000 per year to be paid in equal monthly instalments. They estimated that monthly rates on top of this would be £1,700.

Sharma and Ryan planned to employ themselves along with two other employees, but were aware of the fact that money might be tight, so decided to pay themselves the same salary as the other employees – £19,000 per year.

Other expenses were estimated to be as follows:

- telephone £300 per quarter
- post £50 per month
- courier charges £1,500 per month
- advertising £160 per month plus an additional £500 per quarter
- heat and light £500 per month
- insurance £1,000 per year, payable in January. P3

2. Write a set of notes to accompany the cash flow forecast, explaining to Sharma and Ryan:
   - why a business might experience cash flow problems
   - why this can cause difficulties
   - any potential dangers you can see specific to SIGNature's cash flow forecast. **M1**
3. Sharma and Ryan have asked for further help in preparing for their meeting with the bank manager. They have asked you to suggest actions that they could take to either avoid or help deal with cash flow problems.

   Write a letter to Sharma and Ryan explaining what actions are available and justifying why they might choose to take these actions. **D1**

Grading tips

1. Work in a logical manner, ticking off each item of information as you use it and checking that you have inputted the figures accurately. When drawing a cash flow forecast, it is easier to work from left to right rather than from top to bottom. So, for example, when working out the sales figures, do this for all 12 months before moving on to the next heading. **P3**
2. To analyse the cash flow problems, you must first of all identify where the potential problems lie. To do this, look at the monthly closing balances and then try to identify the cause of that problem and the effect of it. You should also look for trends, as a problem one month is likely to have a knock-on effect the following month. Trends might also occur across items of inflows or outflows – for example, look at whether costs are slowly rising for one particular item of expenditure, such as wages. **M1**
3. Your suggested actions should respond directly to the problems you have identified in the notes you have produced for M1. For each problem, suggest a possible action (solution) and explain to Sharma and Ryan how this action would help to solve the identified problem. In justifying your actions, you should show awareness of the dangers and costs of poor financial planning.

   One good way of supporting your actions is to actually show Sharma and Ryan how the actions would help solve the problems; you could do this by producing a reworked version of the spreadsheet with your actions in place. **D1**

Functional skills

Reworking your spreadsheet to show how suggested actions will solve the cash flow problems will provide evidence of your ability to draw conclusions and provide mathematical justifications.

Communication

Your notes to the cash flow forecast and letter will provide evidence of written documents. They should communicate information, ideas and opinions effectively and persuasively.

3. Prepare profit and loss accounts and balance sheets

Up until this point we have been focusing on whether or not a business has enough cash to survive on a day-to-day basis. Beyond survival, a business is also likely to have an objective of profit. Here we will look at the financial documents that a business produces at the end (or mid-year, called interim accounts) of a financial year. There are two key documents that a firm will produce, and these are:

- **a profit and loss account**, which calculates whether the firm has made a profit or a loss by deducting all expenses from sales revenue
- **a balance sheet**, which calculates the net worth of a business by balancing what the business owns against what it owes.

3.1 Profit and loss account

Purpose and use

A profit and loss account, if produced correctly, will give an accurate calculation showing how much profit or loss the business has made. It records sales, costs and profit over a period of time (normally a year). Once produced, the profit and loss account can be used internally by management to help measure the performance of the business and inform future decision making, and used externally by potential investors and creditors. A creditor, for example, might look at the business's profit and loss account when deciding whether or not to offer trade credit.

Trading account and calculation of gross profit

To give a profit and loss account its full title, it should really be called a trading, profit and loss account, where the first part leading up to the calculation of gross profit is called the trading account. The trading account has three components.

1. **Sales turnover** is the money coming into the business from providing a trade – for example, selling goods, manufacturing goods, providing a service. The calculation for sales turnover is quantity sold x selling price.
2. **Cost of goods sold** includes the costs directly linked to providing that trade, for example, the cost of buying in the goods or the raw materials used to produce the goods. To work out the cost of goods sold, a simple calculation is done to ensure that the figure recorded for cost of goods sold can be directly linked to the goods actually sold and not just all the materials purchased. If, for example, I was to buy 12 balls of wool and knit a jumper, is the cost of wool for that jumper 12 balls? What if I had three spare balls to start with or two balls left at the end? The calculation for cost of goods sold is **opening stock** + purchases – **closing stock**.
3. Gross profit is the amount of money left or the surplus after the cost of goods sold has been deducted from the sales turnover. This is not, however, the business's final profit as there are still other expenses to deduct in the next part of the account. The calculation for gross profit is sales turnover – cost of goods sold.

Trading, profit and loss account for year ended 30th April 2010		
	£000's	£000's
Sales		411,529
Less cost of goods sold		
Opening stock	34,993	
Purchases	128,129	
Closing stock	21,445	
		141,677
Gross profit		269,852

Fig. 5.5: A trading, profit and loss account for Freedom Fashion Ltd.

Key terms

Cost of goods sold – the actual value of stock used to generate sales

Opening stock – the value of stock in a business at the start of a financial year

Closing stock – the value of stock at the end of a financial year

Calculation of net profit

Net profit is the money after all other expenses have been deducted from gross profit and any other revenue income has been added. Revenue income is non-capital income that is received by the business from sources other than sales, for example, discounts received and interest on positive bank balances.

Depreciation appears as an expense in the profit and loss account, as this is a way that accountants can spread the cost of a fixed asset over its lifetime. Depreciation will be explained in more detail under the fixed asset heading when we look at a balance sheet.

The calculation for net profit is:

gross profit – expenses + other revenue income

Fig. 5.6 shows a trading, profit and loss account for Freedom Fashion Ltd.

Freedom Fashion Ltd is an independent chain of fashion stores specialising in surf and outdoor wear in the south-east of England.

Why might a fashion retailer have to hold large amounts of stock?

Trading, profit and loss account for year ended 30th April 2010

	£000's	£000's
Sales		411,529
Less cost of goods sold		
Opening stock	34,993	
Purchases	128,129	
Closing stock	21,445	
		141,737
Gross profit		269,852
Less expenses		
Rent and rates		37,554
Wages and salaries		96,221
Telephone and postage		1,359
Distribution		31,593
Advertising		15,579
Miscellaneous expenses		28,452
Depreciation		17,848
Total expenses		228,696
Revenue income		0
Net profit before tax		41,186

Fig. 5.6: Trading, profit and loss account for year ended 30 April 2010.

Commission received

A business may also receive income from commission sales in addition to its normal sales. For example, www.time2resources.com sells CDs, DVDs and games to support business and enterprise education; these are cash and credit sales. However, it also acts as an agent for SimVenture, a business simulation software company. When it sells a SimVenture licence, it receives commission on these sales.

Transfer of net profit to balance sheet

Tax is to be deducted from the net profit; this is a percentage of the profit that is to be paid to HM Revenue and Customs (HMRC). This then gives net profit after tax.

The business then has to decide how to use this profit. In the case of a company, a proportion of it may be issued to shareholders in the form of dividends. For a sole trader or partnership, it could be taken out of the business as **drawings**. Either some or all of it is likely, however, to be ploughed back into the business – this is called retained profit. Retained profits are transferred from the profit and loss account to the balance sheet.

Activity: Lily's profit and loss account

Assume that Lily's cash flow forecast for year one was accurate and at the end of the year she holds one month's worth of purchases. Use this information to produce a profit and loss account for Lily's cleaning business.

PLTS

Self-managers

It is unlikely that your profit and loss account will be right on your first attempt. You will have to see this as a challenge to try to identify where all the information has not been included or where errors have been made. It is likely to take a few attempts to get your account perfect. Rise to this challenge and seek advice and support when needed.

Functional skills

Use ICT systems

If you produce your profit and loss account using a spreadsheet package, this will demonstrate your ability to select and use ICT systems independently for a complex task.

3.2 Balance sheet

Purpose and use

A balance sheet is a snapshot of a business's net worth at a particular moment in time, normally the end of a financial year. It is a summary of everything that the business owns (its assets) and owes (its liabilities). A balance sheet therefore states the value of a business.

Presentation

Balance sheets can be shown in a vertical or horizontal format, vertical being the most common and therefore the style of presentation we will use in this unit. A vertically presented balance sheet is presented as:

- intangible assets
- + fixed assets
- + current assets
- – current liabilities
- – long-term liabilities
- = net assets.

This is the first half of the balance sheet that calculates the net assets – that is, the worth of the business. Imagine if the business were to close today and you sold all of its assets, then paid off all of its liabilities. This is the amount you would be left with.

The second half of the balance sheet then asks how this has been financed. This shows the **capital employed** and is presented as:

- owners' capital
- + retained profit
- = capital employed.

For a balance sheet to balance, net assets must be equal to capital employed.

Order of permanance

If something is described as permanent, it means it is going to stay in place for a long time. When a business lists its fixed assets, it tends to list them in order of permanence, so the item that will stay in the business the longest and maintain value is listed first. This is normally land or premises as these assets maintain and sometimes even gain in value. Other assets tend to lose value, for example, machinery and vehicles. Vehicles depreciate in value at the quickest rate and are therefore listed last. Fixed assets are therefore listed in the following order of permanence:

- land or premises
- machinery
- vehicles.

Fixed assets

Fixed assets are those items of value that are owned by the business and likely to stay within the business

Key terms

Drawings – sum of money taken out of a business by a sole trader or partner for their own usage

Capital employed – the total amount of money tied up in the business from retained profits and capital investments for more than one year. These are tangible assets and include the premises, fixtures and fittings, equipment and vehicles. It is important that when these are shown in the balance sheet, they are given a realistic value. For this reason they are depreciated on an annual basis. If, for example, a business bought a delivery van for £30,000 and three years later still showed its value as £30,000, this would be unrealistic and inaccurate accounting. The balance sheet should therefore show the historic cost of an asset, the amount by which it has depreciated over its life and then a current value for the asset. This final figure is called the net book value and this represents what the asset is thought to be worth at that moment in time.

There are a number of ways to calculate depreciation but here we are going to use just one method – the straight line method. This method involves reducing the value of an asset by a fixed amount each year. To calculate the amount, the accountant must first of all make two decisions:

how long the asset is expected to be useful to the business

at the end of its useful life, how much it might be worth if sold on or sold for scrap.

Once these decisions have been made, the following formula can be applied:

$$\frac{\textbf{historic}\text{ cost} - \textbf{residual}\text{ value}}{\textbf{expected life}}$$

If therefore a Ford transit van cost £16,000 and it was expected to be used by the business for four years with a resale value of £4,000, the calculation of depreciation would be shown as follows:

$$\frac{£16{,}000 - £4{,}000}{4 \text{ years}} = \frac{£12{,}000}{4} = £3{,}000 \text{ depreciation per year}$$

Key terms

Historic – the cost of an asset when it was first purchased

Residual – the value of an asset when it is disposed of by the business, for example, resale value

Expected life – how long an asset is expected to be used within a business

Current assets – items owned by the business that change in value on a regular basis, such as stock

In the balance sheet, the net book value (the cost of an asset minus depreciation) would therefore be shown as follows.

(1) The value of the van at the end of one year: £16,000 – £3,000 = £13,000

Table 5.3: Example net book value for a Ford transit van.

Year	Cost	Accumulated depreciation	Net book value
1	£16,000	£3,000	£13,000 (1)
2	£16,000	£6,000	£10,000
3	£16,000	£9,000	£7,000
4	£16,000	£12,000	£4,000 (2)

(2) The value of the van at the end of four years matches the residual value used in the calculation above

Current assets

Current assets are those items of value owned by a business whose value is likely to fluctuate on a regular basis. Every time a business makes a transaction, the value of its current assets will fluctuate. Current assets include:

- stock
- debtors
- cash in the bank
- cash in hand.

Stock is the value of stock held at that moment in time. Depending upon the nature of the business it can take three different forms: raw materials, work in progress and finished goods. A business must be careful to give stock a realistic value and not over value stock – for example, stock which they are unlikely to sell because it has gone out of fashion or is damaged.

Debtors are people who owe the business money. Although the business does not yet physically have the money, it is in effect owned by the business. Debtors are customers who have not yet paid for the good or service provided by the business and must be monitored to ensure that they do make the payment by the due date.

Current assets are listed in order of how easy it is to turn them into cash quickly. If, for example, a business has liquidity problems, it may find it difficult to turn stock into cash quickly and in trying to do so, may not receive its true value. In contrast, cash in hand is just that – cash!

Intangible assets

An intangible asset is something that adds value to the business but does not have a physical presence. One example of this that you might see on a balance sheet is 'goodwill'. This means when someone buys an already-established business, they are also buying the goodwill that that business has built up, such as brand recognition or a loyal customer base.

Long-term liabilities

A liability is something that the business owes. If it is classed as long-term, this means the business will pay it back in more than one year. Examples of long-term liabilities include bank loans and mortgages. These are likely to be used to buy fixed assets or to set up the business initially.

Current liabilities

A current liability is something owed by the business that should be paid back in under one year. Examples of current liabilities are overdrafts and creditors. Creditors are people or businesses the business owes money to because it has received a good or service but not yet paid for it.

Fig. 5.7: Why does the value of stock fall when a firm is forced to turn it into cash quickly?

Working capital

Working capital is a very important figure for a business; it represents the business's ability to meet short-term debts. A business with insufficient working capital does not have enough current assets to meet its current liabilities. This is potentially disastrous as if the liabilities have to be paid for now and the business cannot meet these demands from its current assets, then it will have to find the cash elsewhere. This could mean being forced to sell a fixed asset without which the business cannot operate. Working capital is calculated as current assets minus current liabilities. We will look at the significance of working capital in more detail in the final part of this unit when we look at liquidity ratios.

Net assets

Net assets are the figure that represents the total value of all the assets minus the value of the liabilities. Net assets are calculated as follows.

fixed assets + current assets –
(current liabilities + long-term liabilities)

Transfer of net profit from profit and loss account

The final section of the balance sheet basically asks where the business has got the money has come from to finance the value of its net assets. One of the answers to this question is going to be 'from profit'. The net profit from the profit and loss account is therefore transferred to the balance sheet under the heading 'Financed by'.

Capital employed

Profit will not be the only thing that has financed the business's assets. There is also likely to be some initial capital invested in the business – for example, share capital if the business is a company.

Remember

In order for a balance sheet to balance, net assets must be equal to capital employed.

	Cost	Accumulated depreciation	Net book value
	£	£	£
Fixed assets			
Premises	218,000	28,880	189,120
Fixtures and fittings	38,500	15,800	22,700
Vehicles	19,500	19,500	0
Current assets			
Stock			34,294
Debtors			21,455
Cash at bank			0
Cash in hand			381
			56,130
Less current liabilities			
Creditors			17,881
Overdraft			12,389
			30,270
Working capital			25,860
Less long-term liabilities			
Bank loans			50,998
Net assets			186,682
Financed by			
Capital			60,000
Retained profit			126,682
Capital employed			**186,682**

Fig. 5.8: Balance sheet for Freedom Fashion Ltd as at 30 April 2010.

Activity: Lily's balance sheet

Assume Lily's cash flow forecast for her first year was correct. Use the information from her profit and loss (P&L) account along with the additional information provided below to create a balance sheet for Lily's cleaning business.

- Fixed assets are depreciated at 20 per cent per year.
- All purchases are bought in cash.

PLTS

Self-managers

It is unlikely that your balance sheet will be right on your first attempt. You will have to see this as a challenge to try to identify where all the information has not been included or where errors have been made. It is likely to take a few attempts to get it perfect. Rise to this challenge and seek advice and support when needed.

Functional skills

Use ICT systems

If you produce your balance sheet using a spreadsheet package, this will demonstrate your ability to select and use ICT systems independently for a complex task.

Assessment activity 5.3

P4 BTEC

Sharma and Ryan have now been trading as SIGNature Ltd for a year and have again approached you to help them with producing their year end accounts.

1. You are to prepare a profit and loss account and balance sheet for SIGNature Ltd, based on the information provided. Actual sales and purchases for the 12 months were as follows.

Month	Sales	Purchases
January	£25,000	£12,400
February	£28,000	£14,000
March	£32,000	£16,000
April	£36,000	£18,000
May	£43,000	£21,000
June	£49,000	£24,000
July	£49,000	£23,800
August	£52,000	£25,000
September	£47,000	£20,000
October	£34,000	£12,000
November	£31,000	£8,600
December	£18,000	£5,000

- In their first year Sharma and Ryan received 2,080 orders.
- Closing stock was £12,000.
- Rent on their factory premises was £6,500 per quarter.
- Non-domestic rates were 10 instalments of £1,800.
- Sharma and Ryan employed four machine operatives who were each paid £1,400 per month.
- The telephone bill was £60 per month and post £200 per month.
- Distribution costs via a courier were £10 per order.
- They advertised in a local magazine for the year at the cost of £35 per week, and quarterly in a specialist trade magazine at £500 per advert.

Other expenses included:

- repayment of bank loan (£1,000 per month)
- light and heating bills (£2,000 per quarter)
- insurance (£800 per annum, or year).

Sharma and Ryan had fixed assets to the value of £105,000 at the start of the year which they had decided to depreciate on a straight line method at ten per cent per year.

At the end of the year they owed £15,500 to suppliers and were owed £41,000 from customers. There was £17,160 positive balance of cash in the business.

Sharma and Ryan thought it had been a good first year and decided to reward themselves for all their hard work by paying themselves £20,000 each in dividends. P4

Grading tips

1. Work in a logical manner and tick each figure as you use it. When looking at each piece of information, ask yourself whether it should go in the profit and loss account, balance sheet or both. Read each piece of information carefully, taking into account the time frame. If, for example, it says a cost was £x per quarter, you must multiply this by four to get the annual figure.
2. Remember your figures can only be correct when net assets = capital employed on your balance sheet. Use a spreadsheet to present your accounts using formulae to save reworking calculations all of the time, but check your formulae are correct before you start. P4

4. Review business performance using simple ratio analysis

You should now be familiar with the basic language of accounts and the key financial accounts produced by businesses. We will now look at what these accounts actually tell us and how an accountant can use or interpret them. Ratio analysis allows for a more meaningful interpretation of published accounts by comparing one figure to another. Ratio analysis also allows for both **inter-firm** and **intrafirm** comparisons.

Ratios will be used by internal **stakeholders** such as managers and employees, as well as external stakeholders such as investors and creditors.

Key terms

Inter-firm – between different firms, for example, comparing the performance of two different house builders

Intrafirm – within the firm, for example, comparing this year's results with last year's, or the performance of the York branch with the Leicester branch of a retail store

Stakeholder – anyone with an interest in the activities of a business, whether directly or indirectly involved

Table 5.4: Stakeholders and ratio analysis.

Stakeholder	Use of ratio analysis
Manager	• Assess performance of individual branches. • Monitor year-on-year performance. • Inform decision making. • Analyse relationships between revenues and expenses.
Employee	• Negotiate wages and conditions. • Assess security of firm and therefore own job. • Employees may be shareholders.
Shareholder	• Measure return on investment. • Review value of investment.
Creditor	• Assess security of firm. • Decide on credit terms offered. • Determine ability to pay debt.
Competitor	• Measure or benchmark own performance. • Make takeover bids.
Customer	• Negotiate better prices. • Assess security of long-term supplies.

4.1 Profitability

Profitability is a measure of the profit of a firm in relation to another. It allows for a more comprehensive assessment of the performance of a firm by comparing one figure to another. Imagine that there are two firms, A and B, both with a profit of £750,000 per year – how would you be able to tell which one was performing better? If, however, you were told that Firm A has sales revenue of £1.5 million and Firm B has sales revenue of £3 million, then it is clear that Firm A has greater profitability as it is generating the same amount of profit from a lower level of sales, implying it is more efficient and better at controlling its costs.

There are three profitability ratios we will look at here:

- gross profit percentage of sales
- net profit percentage of sales
- return on capital employed (ROCE).

Gross profit percentage of sales

This is calculated using the following formula.

$$\frac{\text{gross profit}}{\text{sales turnover}} \times 100$$

This ratio looks at gross profit as a percentage of sales turnover; this ratio is often referred to as the gross profit margin. It shows us for every £1.00 made in sales how much is left as gross profit after the cost of goods sold has been deducted. A gross profit percentage of sales of 88 per cent therefore means that for every £1 of sales made, 88p is left as gross profit.

If gross profit margin falls from one year to the next or is thought to be too low, a firm may try to reduce the cost of its purchases. This may involve looking for a cheaper supplier, but the firm must try to ensure that this does not affect the quality of the product. Alternatively, it may try to increase sales without increasing the cost of goods sold.

Net profit percentage of sales

This is calculated using the following formula:

$$\frac{\text{net profit}}{\text{sales turnover}} \times 100$$

This ratio looks at net profit as a percentage of sales turnover. This ratio is often referred to as the net profit margin. It shows for every £1 made in sales how much of it is left as net profit after all expenses have been deducted. A net profit percentage of sales of 31 per cent therefore means that for every £1 of sales made, 31p is left as net profit.

If net profit margin falls from one year to the next or is thought to be too low, a firm may look to reduce its expenses, for example, by moving to cheaper premises or cutting staffing costs. Before taking any action, however, the accountant must try to identify the cause of a falling figure – whether it is related to sales, cost of goods sold or expenses – as all of these factors will impact upon the net profit margin.

Worked example

Freedom Fashion Ltd

Sales turnover = £411,529

Gross profit = £269,792

Net profit = £41,246

Gross profit percentage of sales = £269,852/£411,529 × 100 = 65.5 per cent

For every £1.00 Freedom Fashion Ltd makes in sales, 65p is left as gross profit. A fashion retailer is likely to have reasonably high costs of sales due to the nature of their product. If it was a service industry then you might expect this percentage to be higher.

Net profit percentage of sales = £41,246/£411,529 × 100 = 10 per cent

For every £1 Freedom Fashion Ltd makes in sales, just 10p is left as net profit. A fashion retailer is likely to have reasonably high expenses due to the nature of their business. A retail business with a physical location (as opposed to e commerce) may have high overhead costs such as premises and heat and light.

Return on capital employed (ROCE)

This is calculated using the following formula.

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

This ratio shows the percentage return a business is achieving from the capital (or money) being used to generate that return. It shows for every £1 invested in the business in owners' capital or retained profits what per cent is being generated in profit. A ROCE of five per cent means that for every £1 tied up in the business, 5p is being generated in net profit.

Investors will often compare ROCE to the interest rate being offered in a bank or building society to see if their investment is working effectively for them in generating a return.

Worked example

Freedom Fashion Ltd

Net profit before interest and tax = £41,246

Capital employed = £186,682

ROCE = £41,246/186,682 × 100 = 22 per cent

This means that for every £1 being used within the business, there is a return of 22p. This is certainly higher than you could expect from a bank.

4.2 Liquidity

Liquidity ratios measure how solvent a business is – that is, how able it is to meet short-term debts. There are two liquidity ratios we will look at here:

- current ratio
- acid test ratio/liquidity ratio.

Current ratio

This is calculated using the following formula.

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

This ratio shows the amount of current assets in relation to current liabilities and is expressed as x:1. If a firm had a current ratio of 2:1, this would mean that for every £2 it owned in current assets it owed £1 in current liabilities, and this would generally be considered acceptable. If, however, a firm had a current ratio of 0.5:1, this would mean that for every 50p it owned in current assets, it owed £1 in current liabilities. This means if the firm's bank demanded it repaid its overdraft immediately and creditors demanded payment, the firm would not be able to cover these demands from current assets. This is therefore a dangerous position to be in.

Worked example

Freedom Fashion Ltd

Current assets = £56,130

Current liabilities = £30,270

Current ratio = £56,130/£30,270 = 1.85

This means that for every £1 the business owes in short-term debt (that is, its current liabilities), it owns £1.85 in current assets. The business therefore has sufficient liquidity to meet short-term debts.

Acid test ratio/liquidity ratio

This is calculated using the following formula.

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

The acid test is thought to be a tougher measure of a firm's liquidity. Like the current ratio, it shows the amount of current assets in relation to current liabilities, but it does not include stock. This is because stock is considered to be the hardest current asset to turn into cash quickly. The result is expressed as x:1.

Worked example

Freedom Fashion Ltd

Current assets = £56,130

Stock = £34,294

Current liabilities = £30,270

Acid test = £56,130 – £34,294/£30,270
= £21,826/£30,270 = 0.72

This means that for every £1 the business owes in short-term debts, it only has 72p in liquid assets (current assets excluding stock). This figure shows the firm to be **illiquid**, as it could not meet its short-term debts if immediate repayment was demanded. A fashion retailer is likely to have a large amount of its current assets in the form of stock, due to the nature of the firm.

Key term

Illiquid – not easily converted into cash

Activity: Comparing business liquidity

Select a business that you are interested in (or you could use the one you studied in Unit 2 Business resources). Compare the profitability and liquidity of your chosen business to that of Freedom Fashion Ltd.

Which one do you think is performing best? Justify your answer.

PLTS

Reflecting on cause and effect of financial ratios.

Functional skills

Mathematics

Use appropriate checking procedures and evaluate their effectiveness at each stage. Ensure your accounts are accurate before starting your ratio analysis and check the accuracy of each calculation before analysing the results. Draw conclusions and provide mathematical justifications. Analyse results of ratio analysis.

English

Communicate information, ideas and opinions effectively and persuasively. Evaluate ratio analysis.

4.3 Efficiency

Efficiency ratios tend to be used to assess how well management is controlling key aspects of the business, primarily stock and finances. There are three efficiency ratios we will look at here:

- debtors' payment period
- creditors' payment period
- rate of stock turnover.

Debtors' payment period

This is calculated using the following formula.

$$\frac{\text{debtors}}{\text{credit sales}} \times 365$$

If you do not know what percentage of sales were made on credit, then it is acceptable to use the sales figure as given in the profit and loss account. The ratio measures on average how long it takes for debtors to pay; it is expressed as a number of days. For example, if a business has a debtors' payment period of 60 days, this means on average it takes debtors two months to pay for goods or services purchased on credit. A business with cash flow problems will try to reduce its debtors' payment period.

Worked example

Freedom Fashion Ltd

Debtors = £21,455

Sales = £411,529

Debtors' payment period = £21,445/£411,529 × 365 = 19 days

This means that on average it takes a customer 19 days to pay for their purchases. A fashion retailer is unlikely to offer long payment terms.

Debtors' payment period will vary from firm to firm, depending upon the nature and price of items sold and whether the business deals in **business-to-business** or **business-to-consumer** sales. If it is business-to-business, longer payment terms may be given. One business may also give different payment terms to different customers depending upon the size and importance of a customer's business, reliability of payment and discounts offered.

Key terms

Business-to-business – B2B refers to when one business sells to another business – for example, a stationery business selling to a firm of accountants

Business-to-consumer – B2C refers to when one business sells to an individual – for example, a stationery business selling wedding stationery to a bride and groom

Creditors' payment period

This is calculated using the following formula.

$$\frac{\text{creditors}}{\text{credit purchases}} \times 365$$

If you do not know what percentage of purchases were made on credit, then it is acceptable to use the purchases figure as given in the profit and loss account. The ratio measures on average how long it takes a firm to pay for goods and services bought on credit; it is expressed as a number of days. For example, if a business has a creditors' payment period of 30 days, this means on average there is a one-month gap between the business buying the good or service and paying for it. A business with cash flow problems will try to lengthen its creditors' payment period.

Worked example

Freedom Fashion Ltd

Credito`vrs = £17,881

Purchases = £128,129

Creditors' payment period = £17,881/£128,129 × 365 = 51 days

This means that on average the firm pays its suppliers in 51 days. This may mean that some suppliers offer one month's credit and others two months.

Rate of stock turnover

This is calculated using the following formula.

$$\frac{\text{average stock}}{\text{cost of goods sold}} \times 365$$

Average stock is calculated as follows.

$$\frac{\text{opening stock + closing stock}}{2}$$

This ratio measures the average amount of time an item of stock is held by a business, and is expressed as a number of days. If a business has a stock turnover of seven, this means that on average it holds each item of stock for one week. The rate of stock turnover is very much dependent upon the nature of the firm. For example, you could expect a florist or fishmonger to have a much lower stock turnover than a fashion store or car showroom. However, if the rate of stock turnover appears high for the nature of the product, this might result in stock going out of date or out of fashion.

Worked example

Freedom Fashion Ltd

Opening stock = £34,993

Closing stock = £21,445

Cost of goods sold = £141,737

Average stock = £34,993 + £21,445/2
= £56,038/2 = £28,219

Rate of stock turnover = £28,219/£141,737 × 365 = 73 days

This means that on average the business turns its stock over, or sells its stock, every 73 days. This is just over every two months, which is what you might expect from a fashion retailer with approximately six new lines per year.

Assessment activity 5.4

P5 M2 D2

BTEC

Sharma and Ryan now want you to help them understand their financial accounts for SIGNature Ltd. You should prepare a set of numbered appendices to the accounts which explain their profitability, liquidity and efficiency. Only Sharma and Ryan will see these notes and therefore these should give a fair and frank explanation of their performance.

In order to produce these appendices, you should perform the following tasks.

1. Use the profit and loss account and balance sheet you created in Assessment activity 5.3 to carry out the following ratios to measure:
   - profitability
     - gross profit percentage of sales
     - net profit percentage of sales
     - ROCE
   - liquidity
     - current ratio
     - acid test ratio/liquidity ratio
   - efficiency
     - debtors' payment period
     - creditors' payment period
     - rate of stock turnover. P5
2. Explain what each ratio is a measurement of, and what the result means to Sharma and Ryan. Try to explain possible reasons for the ratio and the significance of it to the business's overall financial performance. P5
3. Make a judgement about each ratio – does it imply a good or poor performance? Explain why. M2
4. Write a conclusion to summarise the overall performance of Sharma and Ryan's first year of trading. D2

Grading tips

1. Tick off each ratio from the list as you do it, to ensure you do not miss any out. Double check each calculation for accuracy. Be careful to express each result in the correct way – for example is it a percentage, a ratio or a number of days? It is important to get this right in order to be able to progress on to M2. P5
2. 'Analyse' is an instruction asking you to explain what the results of the ratio analysis mean. One structure which can help with this is to consider cause and effect.
   - Cause is what factors contributed to that outcome – for example, the gross profit as a percentage of sales might be high/low because of sales or cost of materials.
   - Effect is what this now means for the business – for example, what the creditors' payment period would mean for the future cash flow of the business.

   This is not an easy skill and you should try to explain what each ratio measures, what the result means and then try to make a meaningful comment about this figure. Expressions such as 'this means that…' and 'therefore…' can help you develop lines of analysis. M2
3. 'Evaluate' means to make justified judgements. You should look at each ratio and consider whether this is good or bad. There are a number of things you could look at here to help make a judgement, which include:
   - how it will impact upon the future performance of the firm
   - how it compares to other businesses in a similar market
   - what the results would have been if predictions as shown in the cash flow had been true – whether performance would have been better or worse.

   When writing your overall conclusion, remember that this is a new business start-up – consider SIGNature Ltd's performance in this context. D2

Just checking

1. Why is it important for businesses to keep accurate accounts?
2. With the use of appropriate examples, explain the difference between capital income and revenue income.
3. How does the level of capital income available to a business vary depending upon its legal structure? (That is, whether it is a sole trader, partnership or limited company.)
4. With the use of appropriate examples, explain the difference between capital expenditure and revenue expenditure.
5. What is meant by the term intangible asset? Give at least two examples.
6. Describe the purpose and structure of a cash flow forecast.
7. Identify and explain two possible solutions to cash flow problems.
8. What is the difference between a bank loan and an overdraft?
9. What is the purpose of a profit and loss account and a balance sheet?
10. What is the difference between gross profit and net profit? Support your answer with a numerical example.
11. With the use of appropriate examples, explain the meaning of the following terms:
    - **a)** fixed assets
    - **b)** current assets
    - **c)** current liabilities
    - **d)** long-term liabilities.
12. How are net assets and capital employed calculated?
13. What is meant by the term working capital?
14. Briefly explain how a firm's profitability can be measured.
15. What is meant by the term liquidity? Why is this important to the survival of a business?
16. What is the difference between the current ratio and acid test ratio as measures of liquidity?

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Assignment tips

1. When preparing the cash flow forecast, profit and loss account, and balance sheet, try using a spreadsheet package. Check all of your formulae are correct first by putting in simple numbers and seeing if the answer generated is correct.

2. As you use each number, tick it off so you know if you have missed a figure out. Double check that you have entered the correct number into your spreadsheet – if you accidentally type a wrong number in, the spreadsheet cannot spot this.

3. When performing the ratio analysis, do each calculation twice to check it is correct. When explaining the results of the ratio analysis, try to think about the nature of the business in question.