Business Studies
Key Terms

Finance Department

Gearing	Gearing is the amount of debt – in proportion to equity capital – that a company uses to fund its operations. A company that possesses a high gearing ratio/ is highly geared shows a high debt to equity ratio. This potentially increases the risk of… - financial insecurity for the business - high interests have to be paid even when there is no profit, and loans and debentures need to be repaid - Banks and shareholders being reluctant to invest in the business.	Internal Finance	Finances from the business itself.
Start-up Capital	The finance required by a new business to pay for the essential fixed assets and current assets so that it can start trading.	External Finance	Finance from sources outside of and separate from the business.
Working Capital	Capital available to a business in the short term to pay for day-to-day expenses. current assets — current liabilities Current liabilities include: paying invoices, buying raw materials, paying wages/ salaries, paying rent, repayment of short-term debt, paying utilities etc.	Micro-Finance	Money gained from a financial service that lends to small businesses, individuals and entrepreneurs, who cannot raise finances through traditional banking services. • very small amounts borrowed • available to poorer groups in society • may be nowhere else to borrow from • no security required • interest paid
Capital Expenditure	The money spend on non-current assets (fixed assets) lasting more than one year.	Short-term Sources of Finance	Finances that must be paid back within a year and includes: overdraft facility, trade credits, factoring.
Revenue Expenditure	Money spent on day-to-day expenditure, e.g. wages, raw materials.	Long-term Sources of Finance	Funding for over a year and includes: owner's savings/share capital; retained profits; loans; debentures; a mortgage; hire purchase or leasing; grants.

Business Finance	Needed for: starting up a business; expansion of an existing business; and increasing working capital. Factors when considering sources: • the amount required • size and type of business organisation • control over the business • risk and gearing (if it already has loans) • the purpose and period of time required.	Selling Debentures	Issued by both businesses and governments as a way of raising funds. It is a loan that is not secured on anything except the general credit-worthiness of the organisation that issues them. • Raises long-term finance (e.g. 25 years) • gets repaid with interest
Bank Loans (long term)	• Usually quick to arrange • Varying repayment period • Large companies pay a low rate of interest (financial economies of scale) • Interest must be paid • Security/collateral is often required	Grants and Subsidies	• Government grants are not repaid • the money may have conditions attached, such as where the business must be located etc.
Issue of Shares	Limited companies can issue shares to raise funds. • Do not have to be repaid • Can raise co. profile • No interest paid • Dividends expected • Ownership could change hands • Shareholders decide who runs the company • Only used by companies • PLCs: can issue to friends and family only • Ltds: can float on stock exchange and sell to anyone.	Overdraft	• repayable within the year • security not usually required • interest only paid on amount borrowed • flexible form of borrowing • cheaper than loans in short run • more expensive than loans over long term • often repayable on demand • interest rate higher than bank loan • may be refused one until business is established
Leasing (long term)	• large cash outlay not required to purchase asset • maintenance paid for by leasing company • total payment higher than purchase price of the asset	Factoring Debt	**Selling outstanding invoices (money owed by customers to the business) to another company at a discounted amount.** • Immediate cash • no risk of debt not being repaid • receive less than the full amount of debt
Hire Purchase (long term)	• large cash outlay not required to purchase asset • interest paid • asset not owned until last payment made • may require a deposit	Trade Credit	**Buying from a supplier, but paying for the items later.** • If first year of business supply may say no • Interest free, but may be charged higher price • Needs to be repaid, ideally on time, otherwise future goods will not be supplied, and a company remains liable for what it has already received. None payment of goods can lead to bankruptcy. • Will not run out of products to sell • Can sell finished items before raising the money to fund the raw materials.

Sale of Inventories	• reduces storage costs • less capital tied up in inventories • if inventories are too low customers disappointed as demand not quickly satisfied	Cash Inflows	Sum of money received by a business during a time period. From: • Sales of products • sale of assets • borrowed money, e.g. loans etc. • investors' money
Retained Profit	• Not available to start-ups and new businesses • Quick, cheap and easy to access • Opportunity cost if spent - not available for other things • Not repaid • No interest to pay • limited amount available	Profit	Surplus after total costs have been subtracted from sales revenue.
Sale of Existing Assets	• better use of assets • debts not increased • it takes time to sell assets • may not have spare assets to sell	Opening Cash (or bank) Balance	Amount of cash held by the business at the start of the month.
Sole Trader/ Partnership/ Owners' Savings	• no complicated paper work • available quickly • no interest paid, so cheaper than a loan • may not be sufficient • opportunity cost for owner	Net Cash Flow	Difference, each month, between the inflows and the outflows.
Cash Flow	Cash inflows/outflows over a period of time. **Cash flow cycle:** shows the movement of money in and out of the business. Problems: • too little cash - cannot pay bills, production will stop, forced into liquidation	Closing Cash (or bank) Balance	Amount of cash held by the business at the end of each month. This becomes the opening cash balance for the next month.

Cash Outflows	Sums of money paid out by a business during period of time. From: • purchasing goods/components/raw materials using cash • paying bills, e.g. wages • purchasing fixed assets • repaying loans • paying creditors	Income Statements/ Profit and Loss Statement	Document that records income and all costs of a business incurred in earning that income over a certain period of time. Required by law for companies, and need to be accurate and up to date. • show if business has made a profit/loss • judge if cost of sales has risen/fallen • judge if expenses need reducing • see how much retained profit is available • see how available for dividends/drawings • can compare year on year and with other companies. • can manage finances.
Cashflow Forecasts	**E**stimates of future cash inflows/outflows of a business, usually on a monthly basis, showing the expected cash balance at the end of the month. Used: • when starting a new business • to obtain bank loan or overdraft • manage cash flow and avoid running out of money • reduce need for overdraft • help plan for the future	Gross Profit	Sales revenue — cost of sales
Solutions to Cash Flow Problems	**Short-term:** • delay payment to suppliers • ask debtors to pay more quickly • delay or cancel payment of capital equipment • take out bank overdraft or loan. **Long-term** • attract new investors • cut costs • increase efficiency • develop new products to attract more sales • find ways to increase sales revenue (may increase short-term costs)	Net Profit	Profit made after all costs have been deducted from sales revenue. Often just referred to as 'profit'. Gross profit — expenses Why important? • rewards entrepreneurs • rewards risk taking • retained profit is a source of finance • indicator of success
Accounts	Financial records of a business transaction. **Final accounts:** produced at the end of the financial year and give details of the profit/loss made over the year and how much the business is worth.	Cash vs Profit	Cash is not profit as you may not have been paid for all the goods you have sold, but it would still appear in your accounts as a profit made within that time period.
Accountants	Professionally qualified people who have responsibility for keeping accurate accounts and for producing final accounts.	Depreciation	The fall in value of a fixed (non-current) asset over time.

Retained Profit	Net profit reinvested into a company after deducting tax and payments to owners	Capital Employed	shareholders' funds + long-term liabilities Shows the long-term and permanent capital invested in the business.
Dividends	Annual payments from company profits to shareholders.	Account Ratios	Used by: • managers - for taking decisions and controlling the operations of a business • Other companies - for comparison • Investors/lenders/stakeholders - for protecting own interests • Government - to ensure proper taxes being paid But: • not detailed accounts for external users • ratios based on past data • data over time affected by inflation • different accounting methods in different companies/ countries
Balance Sheet	Shows the value of a business's assets and liabilities at a particular point in time and how it has been funded (shares/long-term debts). • shows increase/decrease in value of business • shows if can pay short-term debts • can see how expansion has been paid for • performance using liquidity ratios	Net Profit Margin	$\frac{\text{net profit}}{\text{sales revenue}} \times 100\%$ If increases: gross profit higher or expenses lower. Compare year-on-year, across companies.
Assets	The items of value owned by the business. **Non-current (fixed):** kept for more than one year, e.g. land, buildings, machinery, vehicles. They lose value over time - depreciation. **Current:** only held for short periods of time, e.g. cash, inventories, accounts receivable.	Gross Profit Margin	$\frac{\text{gross profit}}{\text{sales revenue}} \times 100\%$ If increases: either prices were increased or costs of goods are cheaper. Compare year-on-year, across companies.
Liabilities	Debts owed by the business. current: debts that must be paid back within the year - bank over drafts, accounts payable non-current: long-term debts, to be paid back after more than one year - long-term bank loan, debentures	Liquidity	The ability of a business to pay back its short-term debts.

Venture Capital	A loan for a business from a private individual, not a bank. - Venture capitalist: may wish to help run company; can offer knowledge/expertise; take on high risk businesses - Owner: can lose some control of business; may have to give up large share of profit or business	Financial Statements	Financial statements: collection of reports about an organisation's financial results, condition, and cash flows. They are used to: • Determine ability to generate cash, and the sources and uses of that cash. • Show ability to pay back debts. • Amount of tax to be paid. • monitor performance (both immediately and over time) • highlight any looming profitability issues • To derive financial ratios from the statements that can indicate the condition of the business. **Balance sheet, profit and loss account, cash flow statement.**
Factors that Affect Source of Finance	- **Purpose**: buying assets, cash flow etc. - **Time-period** - **Amount needed** - **Legal form and size**: shares and debentures - only for limited companies. Small firms - only limited sources of finances available to them - **Control**: issue too many new shares, the current owners may lose control of the business. - **Risk- gearing**: new loans with pre-existing loans can increase gearing- risk of the business.	Crowd Funding	• A last resort for some who can't get any other source of finance • Raises awareness of the business • Raises awareness of the business finances to other businesses • May attract advice as well as funds • May not attract any investors, or raise enough • Energy may be better spent pursuing another source of funding
Acid Test Ratio	Shows how easily a company can pay its short-term debts, but without the least liquid asset; inventories. $\frac{\text{current assets} - \text{inventories}}{\text{current liabilities}}$ Similar to current ratio but can be slightly less than 1 and still be able to pay current liabilities as they fall due.	Return on Capital Employed (ROCE)	Shows how efficient a business is by looking at profit in relation to the capital used. $\frac{\text{net profit}}{\text{capital employed}} \times 100\%$ If increases: gross profit higher or expenses lower. Compare year-on-year, across companies.
Current Ratio	Shows how easily a company can pay its short-term debts. $\frac{\text{current assets}}{\text{current liabilities}}$ Above 1, and a business has sufficient funds to cover current liabilities. Below 1, then the company is in a dicey situation Above 2, a company has too much working capital, and should be making that money work harder by investing	Opportunity Cost	The next best alternative foregone Opportunity costs represent the potential benefits that an individual, investor, or business misses out on when choosing one alternative over another.
Profitability Ratios	A profitability ratio measures a companies' ability to generate a profit from its operations. - gross/net profit margins - return on capital employed - (cash flow ratios) Used to: attract investors; assess seasonal business; reveal problems in a business (e.g. increasing costs); compare company to company; compare performance over years	Liquidity Ratios	A liquidity ratio is a type of financial ratio used to determine a company's ability to pay its short-term debt obligations. The ratios helps determine if a company can use its current, or liquid, assets to cover its current liabilities. - current ratio/working capital ratio - acid test ratio

Revenue	**Revenue** is the income that a business has from its normal business activities, usually from the sale of goods and services to customers. Revenue is also referred to as **sales** or **turnover**. It is NOT profit or cash flow.		