# Financial analysis

**Executive summary**

The study is being organized to analyze different perspective of finance. It tried to find out the answers of some queries such as what steps can be taken to reach breakeven point. What are the better options of finance to buy machinery, etc? With the help of accounts analysis it was concluded that bank is the better financing option and reducing price of the goods can help to reach the breakeven point

**Contents**



**Introduction**

From the accounting statement the financial and business health of the organization can be understood. It helps to make financial decisions. For instance, How to finance a capital expenditure or what are the income contribution methods. Accounts statement reviles the cost, sales and profit structure. Budget controlling is also a part of it  The Trial balance is a the first step of balance sheet and profit and loss statement of and an organization

**Task I**

**P1.1: Financing the capital expenditure**

Capital expenditure can be funded by many sources. The sources can be both external and internal. Among the internal source the reserve and surplus of the business can be used. In this case I am the sole trader of a small business. I am interested to buy machinery worth £50000. This capital expenditure needs to be financed by some funds. But to decide first whether to buy this machine or not a proper market research in needed. It needs to be examined that how far the investment is going to be fruitful or what can be the expected payback period, and return on investment. Brittain (2002) argued that capital expenditure needs to meet the requirement of the any particular thing and affordability. If the internal sources are concerned every business maintains some reserve and surplus. The expenditure can be financed from them. It is a common practice for the small business trader, that private savings are used as the capital to the business. In this case as well personal funds can be introduced as capital and it can be bought. Apart for internal finance opportunity of external sources are also there. But the main challenge in case on external finance is that a huge interest payment is involved in it. The cost of capital factor should be considered while checking options. Bank is the most common and popular source of financing. Many a times it is seen that small traders do not get entertained by the financial institutions, especially in banks. The barriers are strict credit appraisal technique, demand for guarantee or Collateral security. More over the documentation process is also lengthy and tedious for small business owner. Venture capitalists or moneylenders offer a bit relaxed rules but generally they charge a higher interest rates compared to banks. However comparing ass the possible sources it is advisable that small trades should go for banks because in this case the process gets formalized. Payment of interest is not always bad because it helps to get tax holidays. Benger & Udell (2002) argued that the relationship with banks can help to get finance for small business. However the business still needs some funds internally because no bank finances the 100% of the requirement. Traders need to supplement a portion from his own source.

**P1.2: Income contribution from chain of restaurant**

The income is being generated from offering food and beverages to the customers of the restaurants. Whatever restaurants offer is a combination of goods and services. Here goods are the food and beverages and services means the catering part, hospitality, dining ambiance, etc. As in this case it is a chain of restaurants there should be a uniformity of menu and services. Because of its large volume it can enjoy the economies of scale. It can order bulk quantity of items from the supplier at one go and ask for a lump sum discount from the supplier. Following the theory of Porter's (1980) five force, the organization enjoys a better bargaining power with the supplier. The suppliers might get agreed because he might not be willing to lose the repetitive and bulk business from the chain of restaurant.

The income of the restaurants can be improved if the number of customers gets increased. That will happen if the quality of food and services in improved and consistent. It is important to get the repeat customer for the survival of restaurant business. Kotler (1997) mentioned that it is easier to retain repeat customer compared to developing new customer. The can be some signature dish of the restaurant with which the customers can identify the brand and come back there. It can also offer some innovative ideas such as common membership cards for all the restaurants, combo offer, special birthday and anniversary arrangement, etc.

If the chain of restaurant needs more capital for business expansion and income generation then, the list of the share in the stock market can be a good option. The organization can come out with Initial public offering of the restaurant. While doing this it should be made sure that the management control should not go out of hand for the promoters of the business.

If the brand has developed good brand image the logo is popular then it sell coffee cups and t-shirts bearing that logo. Social media can play a pivotal role to make the brand popular and generate income.

**Task 2**

**P2.1: Cost profit and sales**

**Elements of cost**

There are basically three types of cost components in the cost structure. These are material, labor and direct expenses. Material is basically raw material. It may be manufacturing stage or finished goods stag. For the retail business it is the goods the store purchases with the intention to resale it. It includes primary package materials such as wrappings, cartoons, cardboards and others materials. Material cost includes taxes and duties transportation cost, etcetera. Indirect materials which are not delivered to the customers should also be considered.

Labor cost is the payments which are given employees to get the works done. Employees can be both skilled and unskilled workers. There can be direct labor cost and indirect labor cost. Other expenses includes insurance, machine repairing rent of the premises, etc.

**The gross profit percentage**

The gross profit percentage denotes the connection between the cost of goods sold and the revenue of the company. It represents that the proportion the company earns in every pound of revenue. To calculate it the cost of goods sold has to be subtracted from the revenue earned from the sale. Then it has to be divided by the cost of goods sold and then multiplied by 100

Gross profit percentage= (Revenue- cost of goods sold)/ cost of goods sold*100

**Selling price of product or services**

Determining the selling price of product and services are extremely important for any business. Pricing of product and service may depend on many things. The first component should be the cost structure of the product and services. It should be material cost, labor cost and overhead. The prices should be more that the cost of it. The second component should be what other components are charging. No organization can afford to charge too much high price than its peer. But to get competitive advantage Marks and Spencer can think of offering competitive price compared to competitors. As the volume of the business is big, it can order a big quantity and get a lower price. Front end back end pricing should also be considered. Not only the price of a particular product but also the price of associated does matter when offered in a combined For instance if a shampoo and hair conditioner are offered together, the pricing should be done in this way. Miller (1978) argued that there is a tradeoff between selling time and selling price. Both can be normal and on real time basis.

**P2.2 Stock and cash control**

To run a business properly it is extremely important to take the control over stock and cash. In order to order to prevent thrift or loss the monitoring is important. The stocks should be reviewed periodically. At the outset the company has to give stress on minimum stock level. The minimum stock level should be identified and materials should be reordered upon reaching that level. It is also known reordered level. It should not be the case that the customers require some goods and those goods are not available in the store. This kind of situation not only incurs loss for the retail store but also generates bad reputation for the organization. Rubinstein & Leyland (1981) argued the maintenance is important because the price of goods keep on changing.

Regarding this another two important concepts are Just in Time (JIT) and Economic Order Quantity (EOQ). JIT is practiced to reduce the cost. It should be made sure that whenever goods are required suppliers are ready and capable enough to supply immediately. Marks and Spencer must not stock too mush items in the store. Cause it increases the chances of thrift or misplacement. EOQ is used for the products of which the demand is constant across the year. Here the new consignment is delivered when the inventory is absolutely finished. The process might be helpful to minimize loss but thrift it is a risky process because if the supplier fails to deliver on time then it will overrun the stock.

Regarding the stock usage the two popular concepts are First In First Out (FIFO) and Last In First Out (LIFO). In the case of FIFO the oldest inventory should be documented as dispatched first or sold fist. The price should be adjusted accordingly. In LIFO the newest item should be considered as sold first. According to Hughes & Schwartz (1988) LIFO appears to be a slow process while FIFO ignores the tax savings options. With the help of these theories the retailer would be able to save on the stock part. Apart from this, normal processes like CCTV, and surveillances should also be there. For cash savings regular process like restricted electricity usage and limited stationary usage should be practiced

**Task 3**

**P3.3 purpose and process of budgetary control**

Budget is basically an estimation of income and expenditure. Every individual makes his or her own personal budget depending on the monthly salary and monthly expense. But the budget in accounts includes many other factors such as policies, data documentation and period. In the business it is the common practice that the entire department prepares their own budget depending on their own income and expenditure forecast. For instance, sales, production and administration department prepare its own budget. These are basically sub budgets. However the business organization also prepares a common and overall budget which is known as the master budget. The master budget includes cash flow statement and projected profit and loss. If the sales budget indicates s significant increase in sales, then the production budget should also increase the production to commensurate the sales figure. Additional financial resource should also require funding the extra production.

However, the budget can only be effective if it is controlled properly. As the budgets are made on assumptions, so the actual figures might differ from the budgeted figures. The budgetary control process involves continuous monitoring between budgeted results and actual results and take corrective steps to address it. The basic purpose of budgetary control are planning and forecasting the annual operation and prepare the road map for it. Coordination between the various parts of the organization is the second reason for the budgetary control. Harmony between the departments should be maintained to work together for a defined target. Communication the planning to the entire department is the third purpose of the budgetary control. Motivating the managers also falls under the process. Evaluating the performance of the managers is significant step of budgetary control. The most important stem is variance analysis and addressing the gap between the two. Ueno & Wu (1993) argued that the practice of budgetary control depends on the cultural influence of the organization and the country. The practice differs from organization to organizations. Some organizations are too strict and formal while some others are bit casual.

There are seven stages of budgetary control. In the stage one, the managerial responsibilities are given to the managers. In the stage two action plans, individual budget and every individual's sphere of responsibility is given to them. In the stage three, it is the responsibility of the managers to adhere the budget once it is approved. Performance monitoring and controlling is the fourth stage. Here the actual performance should be compared with the actual result. In the fifth stage the corrective measures has to be taken to minimize the difference between the budgeted and actual performance. In the sixth stage the approval has to be taken from the senior management to maintain the difference from the actual preplanned budget. It can be done only if it is permitted. In the seventh stage, unaccounted difference and unaccounted variances are being addressed.

**P3.4 Analysis of variance**

The cutlery manufacturer has controlled his budget

| | Budget | Actual | Variance |
|---|---|---|---|
| Units sold | 100000 | 75000 | (25000) |
| Materials | £ 15,000 | £ 22,500 | (7500) |
| Direct Labour | £ 22,500 | £ 24,375 | (1875) |

In this case the variance of budget has been calculated on the basis of difference between budgeted figure and actual figure. However this should not be the actual case. Cause the platform are not the same. To bring in the same platform a revised budget is prepared with the actual sales figure. If actual sales figure is not the same, then the other components like material cost, labor cost profit cannot be compared.

| | Budget | Revised budget | Actual | Variance |
|---|---|---|---|---|

| | | | | |
|---|---|---|---|---|
| Units sold | 100000 | 75000 | 75000 | 0 |
| Materials | £ 15,000 | £ 11,250 | £ 22,500 | -£ 11,250 |
| Direct Labour | £ 22,500 | £ 16,875 | £ 24,375 | -£ 7,500 |

Now the variance can be calculated. Here the difference between revised budget and actual figure is considered as the variance. In this case the variance has been increased and it becomes £11250 (A) and £7500 (A) respectively for material and labor. The previous variance was just the ad hoc differences. But in the nest case the variance is the difference for same unit.

**Task 4**

**P3.1 Purpose and structure of trial balance**

Trial balance is the first step of preparing balance sheet and profit and loss account. The book keeping worksheet keeps the balance between debit and credit sides of ledgers. According to Pousite et al, (2011) At first, double entry accounting system is followed to maintain the transactions. Then a number of general ledgers are prepared. Then combining all the ledgers trial balance is prepared. Trial balance is prepared to check if there any error occurred in the entries or not. In the format of trial balance there is a header of the trail balance that contains columns such as particulars, ledger folio, debit amount, credit amount. In the particulars the information related to trial balance is written. In the ledger folio the page number of the ledger is given. The debit amount and credit amount is extracted from the ledgers.

**P3.2 Adjustments to trial balance**

Maxwell (1995) argued that, in adjusted trial balance the credit and debit side has to be equal. If it is not equal then it can be said that some error has happened. Though it does not ensures that a balanced trial balance is error free but it is the first stepping stone.

**P4.1 ratio analysis**

There were some mistakes in the trial balance of R Riggs corrective entries have to be made

These are

i) Furniture A/C Dr 525

To Rigs A/c 525

ii) Bank A/c Dr 50

To Interest Received 50

iii) Expense Dr. 200

Te expense Payable 200

**New profit and loss account**

| | **Item** | £ | £ |
|---|---|---|---|
| | Sales | | 157165 |
| Less | Cost of goods sold | | 94520 |
| | Gross profit | | 62645 |
| | Discounts received | | 160 |
| | **Interest received** | | **50** |
| | | | **62855** |
| | | | |
| Less | Wages and salaries | 31740 | |
| | Rent | 3170 | |
| | Van running cost | 820 | |
| | Bad debts | 730 | |
| | Doubtful debt provision | 91 | |
| | Depreciation | 1630 | |
| | **Additional furniture** | **525** | |
| | **Expenses** | **200** | |
| | | **38906** | |
| | Net profit | | |

| | | | |
|---|---|---|---|
| | | | **23949** |

With reference to R Riggs some ratios have been calculated.

<u>Gross Profit Margin = Gross Profit/ Net Sale*100</u>

Or Gross Profit Margin =£62645/£157167*100

Or 39.85% Ans.

<u>Net profit margin = Net profit/ Net Sales*100</u>

Or Net profit margin £23937/£157167*100

Or 15.23% Ans.

<u>Current Ratio = Current Assets / Current Liabilities</u>

Or current ratio = £23894/ £5657

Or 4.22 Ans.

<u>Acid test ratio = (Cash + accounts receivables+ short term investments)/current liability</u>

Or Acid test ratio = (£2400+£23894) £5657

Or 26294/5657= 3.8 Ans.

<u>Debtor's Collection Period = Debtors (amount of money owed) / Sales Turnover x 365</u>

Or Debtors collection period = £12316/£157165*365

Or 28.60 Ans

<u>Creditors payment period = Payables/ cost of sales*365</u>

Or Creditors payment period = 5245/ 94520*365

Or 20.25 Ans.

**Stock turnover ratio = Cost of goods sold / inventory**

Or sales inventory ratio = 94520/2400

Or 39.38 Ans.

**P4.2 Future of management accounting strategies**

In future the management strategies will be entirely digital; technology enabled data analysis will be there. The requirement of manual skills will be less. It is forecasted that risk management will be a key area in future strategies.

**Task 5**

**P5.1 cost scenario**

There are different kinds of cost is available in a cost structure. It can be variable cost, fixed cost and semi variable cost.

**Variable cost:** It is the cost which changes proportionately and accordingly to the sales volume. That means it is being incurred with each unit sold. According to Garrison, Noreen, Brewer (2006), Variable cost is also the marginal cost. For instance cost of packaging material in a retail shop is variable cost.

**Fixed cost:** Fixed cost is the cost which the company has to incur regardless of the scale of the production. McEachern (2012) argued that, in short run, it remains constant and does not vary with the number of goods sold. Company incurs it even if it is not producing anything. Rent for the shop premises or the cost of furniture in the retail shop are the example of fixed cost.

**Semi variable cost:** semi variable cost is the combination of both fixed cost and variable cost. It contains both fixed and variable component. Telephone bill is an example of semi variable cost. Even if one does not use telephone, he has to pay a minimum maintenance cost. More over to use it per call rate is also there.

So, total cost includes fixed cost, variable cost and semi variable cost.

**Breakeven point:** breakeven is no profit, no loss point. In finance, it appears as when

Fixed cost = (sales per unit- variable cost per unit)

**P 5.2Contribution Calculation**

According to the case

**Budgeted number of units: 10,000**

| | £000 |
|---|---|
| Sales revenue | 100 |
| Less: Variable costs | 80 |
| **Contribution** | **20** |
| Less: Fixed costs | 30 |
| **Budgeted loss** | **(10)** |

Here the sales price is £10 per unit (sales revenue £100000/ units-10000)

Variable cost £8 per unit (total Variable cost-£80000/ units-10000)

i) According to the first proposal, the sales price will be reduced by 10%. Currently the sales price is £10. So , the new price will be £9. [10-(10*10/100)] And the variable cost is £8 per unit. So, the new contribution (sales price per unit- variable cost per unit is £1). Fixed cost is £30000. The number of sales unit to achieve the breakeven is assumed to be X

Then, £1*X= £30000

Or X = 30000 units Ans.

ii) According to the second proposal sales price will be increased by 10%.

Currently the sales price is £10. So, the new price will be £11. [10+(10*10/100)] And the variable cost is £8 per unit. So, the new contribution (sales price per unit- variable cost per unit is £3). Fixed cost is £30000. The number of sales unit to achieve the breakeven is assumed to be Y.

Then £3*Y=£30000

Or, Y= 10000 units Ans.

According to the third proposal the quality of the product is increased. To do that the variable cost has also increased by £1.5 per unit . So the new variable cost would be £9.5. The new contribution will be £0.5(£10- £9.5). The fixed cost remained same as £30000 the number of sales unit to achieve the breakeven is assumed to be Z.

Then £ 0.5 Z=£30000

Or Z= 60000 Units Ans.

**P5.3 decision making**

After doing a comparison between all the three options the study found that the second option that is increasing the sales price by 10%. Cause in this case it would be easier to sale 10000 units rather than selling 30000 or 60000 units. But in this case the concept of price elasticity of demand has to be considered. According to the law of demand the sales volume can go down if the product price is increased. Same logic can be applicable for third option. If the quality is increased, then it would also be examined that how far the demand or sales get increased due to the increase of product quality.

**Conclusion**

Proper decisions can be taken with the help of accounting analysis. The study found that banking is the better way of capital financing it came to know that apart from regular restaurant operation it can also earn from capital market. It also suggested that to reach breakeven it is the better option to reduce the price compared to any other options

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