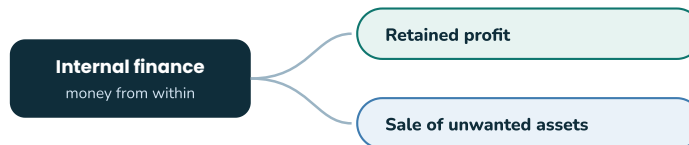


 Learning goals

- ✓ Explain what internal finance means
- ✓ Describe retained profit, sale of assets and owner's capital
- ✓ Give advantages and drawbacks of each
- ✓ Recommend an internal source for a situation

 Key words

-  **Internal finance** Money raised from within the business itself.
-  **Retained profit** Profit kept in the business rather than paid to owners.
-  **Sale of assets** Selling items the business owns to raise cash.
-  **Owner's capital** The owner's own savings put into the business.
-  **Asset** Something the business owns, e.g. tools, vehicles or stock.

 What you need to know

Internal finance comes from within the business itself.

1. What “internal” means

Internal finance is money raised **from within the business itself** — not borrowed from outside. The three main internal sources are **retained profit**, **sale of assets**, and **owner's capital**.

2. The three internal sources

Retained profit is profit **kept back** in the business rather than taken by the owners. It is “free” (no interest) and adds no debt, but it can only be used if the business is actually making a profit. **Sale of assets** means **selling things the business owns** but no longer needs (e.g. an old van) to raise cash — quick, but you can only sell what you own and you lose that asset. **Owner's capital** is the **owner's own savings** put in — no interest and full control kept, but it risks the owner's personal money.

“Internal finance uses the firm's own money — no interest, but limited by what the business has.”

 Test yourself

Cover the answers below, answer Q1–Q6, then check.

- Q1** What are internal sources of finance?
Q2 Give three internal sources of finance.
Q3 What is retained profit?

- Q4** Give one advantage of using retained profit.
Q5 What is sale of assets?
Q6 Give one drawback of selling assets.

ANSWERS

- A1** Money raised from within the business itself.
A2 Retained profit, sale of assets, and owner's capital.
A3 Profit kept in the business rather than paid out to owners.
A4 It is free (no interest) and does not increase debt.
A5 Selling items the business owns but no longer needs to raise cash.
A6 The business loses an asset it may need, and can only sell what it owns.

 Learning goals

- ✓ Explain what external finance means
- ✓ Describe the main external sources
- ✓ Give advantages and drawbacks of each
- ✓ Recommend a suitable external source for a situation

 Key words

External finance Money raised from outside the business.



Bank loan A sum borrowed and repaid with interest over time.



Overdraft Spending more than is in the bank account, up to a limit.



Trade credit Buying goods now and paying the supplier later.



Share issue Selling shares in a company to raise money.

 What you need to know

External finance is raised from outside the business.

1. Borrowing from a bank

External finance is money raised **from outside** the business. A **bank loan** is a sum borrowed and repaid in instalments **with interest** — good for larger, planned spending, but it raises costs and must be repaid. An **overdraft** lets a business **spend a bit more than is in its account**, up to a limit — handy for short-term gaps, but interest is high.

2. Other external sources

Trade credit means buying goods now and **paying the supplier later** (e.g. in 30 days) — it helps cash flow but isn't free money. A **share issue** sells **shares in a company** to raise large amounts (limited companies only), but owners give up some control. Other sources include **leasing** (renting an asset instead of buying), **government grants** (often no repayment, but conditions apply), **crowdfunding** (small amounts from many people online), and **family and friends**.

"Loans suit big, planned costs; overdrafts and trade credit suit short-term cash gaps."

3. Choosing wisely

The right source depends on **how much** is needed, **how long** for, the **cost** (interest), and the **type of business** (only companies can issue shares). A sole trader like Pedal Power can't issue shares, so it relies on loans, overdrafts, trade credit, leasing or grants.

 Test yourself

Cover the answers below, answer Q7–Q15, then check.

Q7 What are external sources of finance?

Q8 What is a bank loan?

Q9 What is an overdraft?

Q10 What is trade credit?

Q11 What is a share issue?

Q12 What is a government grant?

Q13 What is crowdfunding?

Q14 What is leasing?

Q15 Give one drawback of a bank loan.

ANSWERS

A7 Money raised from outside the business.

A8 A sum borrowed from a bank, repaid with interest over time.

A9 An arrangement letting a business spend more than is in its account, up to a limit.

A10 Buying goods now and paying the supplier later (e.g. in 30 days).

A11 Selling shares in the company to raise finance (for a limited company).

A12 Money given by the government that usually does not need repaying.

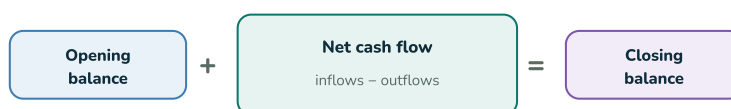
A13 Raising small amounts of money from many people, often online.

A14 Renting an asset rather than buying it, paying regular amounts.

A15 Interest must be paid, increasing the total cost.

 Learning goals

- ✓ Explain cash flow and why it matters
- ✓ Identify inflows and outflows
- ✓ Calculate net cash flow and closing balance
- ✓ Suggest ways to improve cash flow

 Key words**Cash flow** The money flowing into and out of a business over time.**Inflow** Money coming in (e.g. from sales).**Outflow** Money going out (e.g. wages, rent, stock).**Net cash flow** Inflows minus outflows in a period.**Closing balance** Opening balance + net cash flow. What you need to know

Closing balance = opening balance + net cash flow.

1. Cash flow and why it matters

Cash flow is the money flowing **into and out of** a business over time. **Inflows** are money coming in (mostly sales); **outflows** are money going out (wages, rent, stock). Cash flow matters because a business can be **profitable but still fail** if it runs out of cash to pay its bills on time — this is why cash is sometimes called the lifeblood of a business.

Pedal Power (£)	Jan	Feb	Mar
Opening balance	2,000	3,000	2,500
Inflows (sales)	6,000	5,500	7,000
Outflows	5,000	6,000	5,500
Net cash flow	+1,000	-500	+1,500
Closing balance	3,000	2,500	4,000

"Net cash flow = inflows – outflows. Closing balance = opening balance + net cash flow."

2. The cash-flow forecast

A **cash-flow forecast** predicts future inflows and outflows. Two key calculations: **net cash flow = inflows – outflows**, and **closing balance = opening balance + net cash flow**. Each month's closing balance becomes the next month's opening balance.

3. Improving cash flow

If cash runs low, a business can **chase customer payments** sooner, **delay paying suppliers** (using trade credit), **cut or delay costs**, or **arrange an overdraft**. Each helps the timing of cash, even if it doesn't make the business more profitable.

 Test yourself

Cover the answers below, answer Q16–Q23, then check.

Q16 What is cash flow?

Q17 What is a cash-flow forecast?

Q18 What are cash inflows?

Q19 What are cash outflows?

Q20 What is net cash flow?

Q21 How do you calculate the closing balance?

Q22 Why is cash flow important?

Q23 Give one way to improve cash flow.

ANSWERS

A16 The money flowing into and out of a business over time.

A17 A prediction of future cash inflows and outflows.

A18 Money coming into the business (e.g. from sales).

A19 Money going out of the business (e.g. wages, rent, stock).

A20 Inflows minus outflows in a period.

A21 Opening balance + net cash flow.

A22 A business can be profitable but still fail if it runs out of cash to pay its bills.

A23 Chase customer payments, delay paying suppliers, cut costs, or arrange an overdraft.

 Learning goals

- ✓ Define fixed, variable and total costs
- ✓ Calculate total revenue and profit
- ✓ Explain profit, loss and interest
- ✓ Use the formulas with business data

 Key words

 **Fixed costs** Costs that do not change with output (e.g. rent).

 **Variable costs** Costs that change with output (e.g. materials).

 **Total costs** Fixed costs + variable costs.

 **Total revenue** Selling price × quantity sold.

 **Profit** Total revenue – total costs.

 What you need to know

Total costs = fixed + variable; profit = revenue – total costs.

1. Fixed, variable and total costs

Fixed costs do not change with how much is made or sold — for Pedal Power, shop rent and insurance stay the same whether it sells 10 bikes or 100. **Variable costs** change with output — the more bikes it builds, the more parts it buys. **Total costs** = fixed costs + variable costs.

2. Revenue and profit

Total revenue = selling price × quantity sold. **Profit** = total revenue – total costs. If total costs are greater than revenue, the business makes a **loss**. **Interest** is the cost of borrowing money (or the reward for saving) — a cost to watch if the business has loans.

“Total costs = fixed + variable. Revenue = price × quantity. Profit = revenue – total costs.”

3. Fixed or variable?

Knowing which costs are fixed and which are variable helps with pricing and break-even (next lessons). Rent, salaries and insurance are usually **fixed**; raw materials, parts and packaging are usually **variable**.

 Test yourself

Cover the answers below, answer Q24–Q31, then check.

Q24 What are fixed costs?

Q25 What are variable costs?

Q26 How do you calculate total costs?

Q27 How do you calculate total revenue?

Q28 How do you calculate profit?

Q29 What is a loss?

Q30 What is interest?

Q31 Give an example of a fixed cost for Pedal Power.

ANSWERS

A24 Costs that do not change with output (e.g. rent).

A25 Costs that change with output (e.g. materials).

A26 Fixed costs + variable costs.

A27 Selling price × quantity sold.

A28 Total revenue – total costs.

A29 When total costs are greater than total revenue.

A30 The cost of borrowing money (or the reward for saving).

A31 Shop rent or insurance.

 Learning goals

- ✓ Explain what ARR measures
- ✓ Calculate average annual profit
- ✓ Calculate ARR as a percentage
- ✓ Use ARR to compare investments, and know its limits

 Key words

 **Investment** Money spent now to earn a return in future.

 **Average rate of return (ARR)** Average yearly profit as a percentage of the cost.

 **Average annual profit** Total profit ÷ number of years.

 **Return** The profit earned from an investment.

 **Percentage** A figure out of 100, useful for comparing.

 What you need to know

$$\text{ARR (\%)} = (\text{average annual profit} \div \text{cost of investment}) \times 100$$

a higher percentage means a better return for each £ invested

ARR shows the average yearly profit as a percentage of the investment's cost.

1. What ARR measures

The **average rate of return (ARR)** compares the **average yearly profit** of an investment with its **cost**, as a percentage. It lets a business compare two options fairly — the higher the ARR, the better the return for each pound spent.

Cost of investment (new workshop tools)	£10,000
Total profit over 5 years	£15,000
Average annual profit = $15,000 \div 5$	£3,000
ARR = $(3,000 \div 10,000) \times 100$	30%

"Average annual profit = total profit ÷ years. ARR = (average annual profit ÷ cost) × 100."

2. The two-step calculation

Step 1: **average annual profit** = total profit ÷ number of years. Step 2: **ARR** = (average annual profit ÷ cost of investment) × 100.

3. Using ARR — and its limits

A business usually picks the option with the **higher ARR**. But ARR has limits:

- it ignores when the money comes in (early returns are better)
- it ignores risk
- non-financial factors

So it should not be the only thing considered

 Test yourself

Cover the answers below, answer Q32–Q36, then check.

Q32 What is the average rate of return (ARR)?

Q33 How do you calculate ARR?

Q34 How do you find average annual profit?

Q35 What does a higher ARR mean?

Q36 Give one drawback of ARR.

ANSWERS

A32 A way to compare an investment's yearly profit with its cost, as a percentage.

A33 (Average annual profit ÷ cost of investment) × 100.

A34 Total profit ÷ number of years.

A35 A better return on the investment.

A36 It ignores when the money comes in and the risk involved.

Learning goals

- ✓ Explain the break-even point
- ✓ Calculate the margin of safety
- ✓ Calculate contribution and break-even output
- ✓ Read a break-even chart

Key words



Break-even point The output where total revenue equals total costs.



Contribution Selling price – variable cost per unit.



Margin of safety Actual output – break-even output.

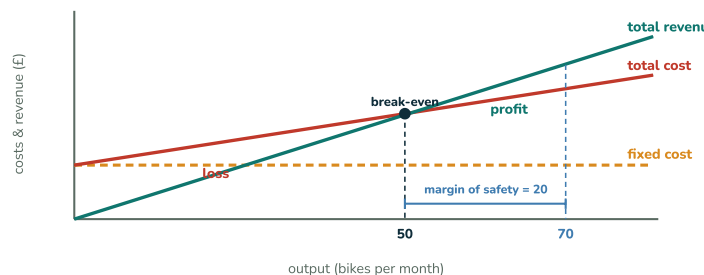


Total revenue Selling price × quantity sold.



Fixed costs Costs that do not change with output.

What you need to know



On a break-even chart, the business breaks even where total revenue meets total costs.

1. The break-even point

The **break-even point** is the output where **total revenue equals total costs** — the business makes **no profit and no loss**. Sell more than this and it makes a profit; sell fewer and it makes a loss. On a break-even chart, it's where the total revenue line crosses the total costs line.

2. Calculating break-even

First find the **contribution** per unit: **selling price – variable cost per unit**. Then: **break-even output = fixed costs ÷ contribution per unit**.

For Pedal Power:

a serviced bike sells for £200

variable cost £100

fixed costs £5,000 a month

Contribution = $200 - 100 = £100$. Break-even = $5,000 \div 100 = 50$ bikes. The chart above shows revenue meeting total costs at 50 bikes

"Contribution = price – variable cost. Break-even = fixed costs ÷ contribution."

3. Margin of safety

The **margin of safety** is how far actual sales are **above** break-even: **actual output – break-even output**. If Pedal Power sells 70 bikes and breaks even at 50, the margin of safety is **20 bikes** — sales could fall by 20 before it makes a loss.

Test yourself

Cover the answers below, answer Q37–Q43, then check.

Q37 What is the break-even point?

Q38 How do you calculate break-even output?

Q39 What is contribution per unit?

Q40 What is the margin of safety?

Q41 How do you calculate the margin of safety?

Q42 What happens above the break-even point?

Q43 Give one benefit of break-even analysis.

ANSWERS

A37 The output where total revenue equals total costs (no profit or loss).

A38 Fixed costs ÷ (selling price – variable cost per unit).

A39 Selling price – variable cost per unit.

A40 The amount by which actual sales exceed the break-even point.

A41 Actual output – break-even output.

A42 The business makes a profit.

A43 It shows how many units must be sold to avoid a loss, helping planning.

 Learning goals

- ✓ Read an income statement
- ✓ Calculate gross profit and net profit
- ✓ Calculate gross and net profit margins
- ✓ Interpret performance and know the limits of the figures

 Key words

Income statement A statement of revenue, costs and profit over a period.



Cost of sales The direct cost of the goods that were sold.



Gross profit Revenue – cost of sales.



Net profit Gross profit – other expenses.



Profit margin Profit as a percentage of revenue.

 What you need to know

An income statement works down from revenue to gross profit to net profit.

1. The income statement

An **income statement** shows how a business performed over a period. It works downwards: **revenue – cost of sales = gross profit**, then **gross profit – expenses = net profit**. **Gross profit** is profit before running costs; **net profit** is what's left after them.

Revenue	£80,000
Cost of sales	(£50,000)
Gross profit	£30,000
Expenses	(£18,000)
Net profit	£12,000

2. Profit margins

Margins show profit as a **percentage of revenue**, which makes comparing years or businesses fair. **Gross profit margin = (gross profit ÷ revenue) × 100**. **Net profit margin = (net profit ÷ revenue) × 100**. Using the table: gross margin = $(30,000 \div 80,000) \times 100 = 37.5\%$; net margin = $(12,000 \div 80,000) \times 100 = 15\%$.

"Gross profit = revenue – cost of sales. Net profit = gross profit – expenses. Margin = (profit ÷ revenue) × 100."

 Test yourself

Cover the answers below, answer Q44–Q50, then check.

Q44 What is an income statement?

Q45 What is gross profit?

Q46 What is net profit?

Q47 How do you calculate gross profit margin?

3. Interpreting – and the limits

A **higher net profit margin** means a business keeps more of each pound as profit and is usually more efficient. But financial statements have **limits**:

- they show the past
- not the future
- ignore non-financial factors like staff morale or reputation

So they should be read alongside other information

Q48 How do you calculate net profit margin?

Q49 What does a higher net profit margin show?

Q50 Give one limitation of financial statements.

ANSWERS

A44 A financial statement showing revenue, costs and profit over a period.

A45 Revenue – cost of sales.

A46 Gross profit – other expenses (running costs).

A47 $(\text{Gross profit} \div \text{revenue}) \times 100$.

A48 $(\text{Net profit} \div \text{revenue}) \times 100$.

A49 The business keeps more of each pound of sales as profit / is more efficient.

A50 They show the past, not the future, and ignore non-financial factors.