The Role of Financial Planning 4

1. Identify the measure of the profit that owners receive on the money they invest in a business.

Return on Owner’s Equity (ROE) is a profitability ratio which measures the proportion of the net profit that is generated to the owners from the money invested in the business. It is calculated through the following equation:

ROE = (Net profit/Total Owner’s Equity) x 100%

2. At what point in the financial planning cycle would records be maintained?

The financial planning cycle involves a number of steps to effectively plan, manage and evaluate the business operations. Records of business transactions would start to be maintained in the control steps of the financial planning cycle. At this step, records are entered into the database which is to be compiled for financial reports at the end of the financial period. The records can be compared against financial plans to see if outcomes have met expectations.

3. Explain how profitability and liquidity differ.

Profitability refers to the earning potential of the business. Future and current investors are interested in the profitability of a business as it indicates if they will see a return on the money that they put into the business. On the other hand, liquidity measures the ability of the business to pay its current liabilities by using its current assets. Liquidity measure is used to ensure that the business would be continuously viable to fulfil its current financial obligations, thus allowing the business to maintain or improve its credit-rating.

4. Provide examples of businesses that may be highly profitable but have low liquidity, and businesses that may have low profitability but are highly liquid.

Small retail businesses such as local groceries often have low profitability but are highly liquid. They sell their products with low profit margin due to the competitive nature of their market. However, their customers use cash as their payment instrument, which increases the liquidity of the business.

Exporters are businesses which would be highly profitable but have low liquidity. They supply their goods or services to the global market for global consumers which demand the goods highly, thus allowing exporters to charge at higher profit margins. However, their customers often pay for the goods by credit or instalments which could extend up to months, thereby reducing the liquidity of the business.

5. Describe the key differences between general and special-purpose financial reports, with reference to a) who they are for, and b) what they are for.

General-purpose financial reports include balance sheets, revenue statements and statements of cash flow. They will often contain general information such as notes to financial statements, the auditors report and a director declaration. In contrast, special-purpose financial reports are constructed specifically to assist the understanding of a particular user and include such financial information as breakeven analyses, sales reports and budgets. Therefore, general-purpose financial reports are suitable to assist the general public in investment decision making while special-purpose financial reports provide information for internal stakeholders such as managers, so that they can make managerial decisions for the business.

6. Place the following steps of the financial planning cycle in the correct order:

- **Analyse reports**
- **Maintain record systems**
- **Address present financial situation**
- **Determine the financial elements of the business plan**

1. Address present financial situation
2. Determine the financial elements of the business plan
3. Maintain record systems
4. Analyse reports

7. Describe the two main ways a business can grow.

Businesses can achieve growth in two ways. Internal growth occurs when a business uses its savings (retained profits) to invest in such projects as introducing new products. External growth occurs when a business buys or merges with another business.

