

Undergraduate Diploma in Business Administration

Module 03 Financial Analysis MQF Level 5 (8 ECTS)

Lecture 6

Phase 2: Management, Funding, & Internal Decisions



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Date: 29th April 2026

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- 01** Distinguish between accounting information needed for short-term and long-term decisions.
- 02** Identify which financial statement supports which type of management decision.
- 03** Interpret the Income Statement, Balance Sheet, and Cash Flow Statement together.
- 04** Apply trend and common-size analysis to surface meaningful insights.
- 05** Translate findings into structured recommendations to management.





Decision Making & *In Financial Management*

What is a decision in accounting terms?

- **Decision is a choice between alternative uses of resources. Every decision has four ingredients:**

COST

What you give up to take the action.

BENEFIT

What you expect to gain in return.

TIME HORIZON

When the costs and benefits actually occur.

CERTAINTY

How confident we are in the numbers behind it.

The role of accounting information is to reduce uncertainty, so the manager can choose the alternative most likely to add value.

Short-term decisions

UP TO 1 YEAR

Use the resources we already have

Existing capacity. Existing assets. Existing staff. The structure of the business is not changing — only how we use it this month, this quarter, this year.

Usually reversible.

Lower risk.

Focus on cash and contribution.

TYPICAL EXAMPLES

- Accept a special order at a discounted price.
- Make a component in-house or buy it from a supplier.
- Which products to push this month.
- Offer 30-day credit terms to a new customer.
- Cover next week's salaries with current cash.

Should we do this NOW?

Long-term decisions

MORE THAN 1 YEAR

Change the structure of the business

Capacity changes. Assets change. The financing mix changes. The business commits resources for years before knowing the full result.

Often irreversible.

Higher risk.

The time value of money matters.

TYPICAL EXAMPLES

- Open a second branch.
- Replace one delivery van with a fleet of three.
- Invest in new machinery costing €200,000.
- Take a 5-year bank loan to fund expansion.
- Acquire a competitor.

Should we COMMIT to this?

Short-term vs long-term, side by side

ASPECT	SHORT-TERM	LONG-TERM
Time horizon	Up to 1 year	More than 1 year (often 3–10)
Reversibility	Usually reversible	Often irreversible
Capacity	Fixed — use what we have	Variable — we are changing it
Cost focus	Variable cost, contribution, cash flow	Total cost, including capital cost
Time value of money	Usually ignored	Essential — discount the cash flows
Main statements	Income Statement, cash flow forecast	Balance Sheet, capital budgeting
Key question	Should we do this now?	Should we commit to this?

What information do short-term decisions need?

01 Variable costs per unit

Costs that change with output: materials, packaging, hourly wages.

02 Selling price

And any expected discounts or special terms.

03 Contribution per unit

Selling price – variable cost. Tells us what each unit contributes.

04 Available capacity

Can we produce more without buying new equipment?

05 Short-term cash position

Do we have cash to fund this before the customer pays?

06 Relevant fixed costs

Only those that change because of the decision.

KEY PRINCIPLE — Ignore sunk costs. Ignore allocated overheads that don't change. Focus only on what changes.

Scenario

**A bakery sells bread at €3.00.
Variable cost is €1.20. Fixed
costs €4,000/month. Spare
capacity exists. A hotel offers
€1.80 per loaf for 500 loaves.**



Scenario Decision

WRONG ANALYSIS — full cost

Total cost per loaf includes a share of fixed costs.

“€1.80 is below our normal cost — refuse.”

Why this is wrong:

Fixed costs of €4,000 are paid whether the order is accepted or not. They are irrelevant to a short-term decision.

CORRECT ANALYSIS — incremental

Incremental revenue	$500 \times \text{€}1.80$	€900
Incremental cost	$500 \times \text{€}1.20$	€600
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Added contribution		€300

DECISION — ACCEPT the order

What information do long-term decisions need?

01 Initial investment

Asset cost, installation, training, working capital tied up.

02 Useful life

Estimated period the investment will produce value.

03 Forecast cash flows

Year-by-year inflows and outflows over the project's life.

04 Salvage / residual value

What the asset will be worth at the end.

05 Cost of capital

The return our funds must earn — interest plus owners' expectations.

06 Risk factors

Inflation, demand uncertainty, competitor reaction, taxes.

KEY PRINCIPLE — €1 today is worth more than €1 in three years. Long-term decisions must respect the time value of money.

The time value of money

€1,000 today is worth more than €1,000 in three years' time. Why?

INVESTMENT

It can be put to work today and earn a return in the meantime.

INFLATION

Prices tend to rise, so €1,000 buys less in three years than it does now.

RISK

Future cash flows are uncertain — they may arrive late or not at all.



The Kahoot! logo is centered on a rectangular background divided into four quadrants by a vertical and a horizontal line. The top-left quadrant is red, the top-right is blue, the bottom-left is yellow, and the bottom-right is green. Each quadrant contains a faint, stylized map of a world region. The word "Kahoot!" is written in a large, white, rounded, sans-serif font across the center of the background.

Kahoot!

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Applying

Financial Statements – from 3 statements to one coherent story to the business.

Quick recap – the three statements

INCOME STATEMENT

Revenues and expenses over a period.

ANSWERS

Did we make a profit?

BALANCE SHEET

Assets, liabilities, equity at a point in time.

ANSWERS

What do we own and owe?

CASH FLOW

Cash inflows and outflows over a period.

ANSWERS

Where did the cash go?

Profit $\neq$ Cash

A profitable business can run out of cash. A cash-rich business can be losing money. Read all three statements together — never one in isolation.

How managers actually use each statement

1. Is revenue growing, flat, or declining year-on-year?
2. Are gross margins holding up, or is something squeezing them (rising costs, discounting)?
3. Are operating expenses growing faster than revenue?
4. Is the bottom-line profit consistent with what we promised the owners?

FROM THE INCOME STATEMENT



1. Do we have enough current assets to cover current liabilities? (liquidity)
2. Are we relying too heavily on debt? (gearing/leverage)
3. Is too much money tied up in stock or in customers who pay slowly?
4. Are our fixed assets being replaced or are they ageing?

FROM THE BALANCE SHEET



- Is the business generating cash from its core operations, or only from borrowing?
- How much cash is being spent on new investments?
- Are we paying down debt or taking on more?
- Is there enough free cash to pay dividends or fund growth?

**FROM THE CASH FLOW
STATEMENT**



Three techniques to interpret statements

01

HORIZONTAL

Trend analysis

Compare the same line item across periods. Growth, decline, or volatility jumps out immediately.

02

VERTICAL

Common-size analysis

Express each item as a % of revenue (or total assets). Strips out size and shows structural changes.

03

COMPARISON

Benchmarking

Compare against the company's past, against budget, and against industry. Context decides if a number is good or bad.

These three techniques surface most insight before any ratio is calculated.

Trend Analysis - Example

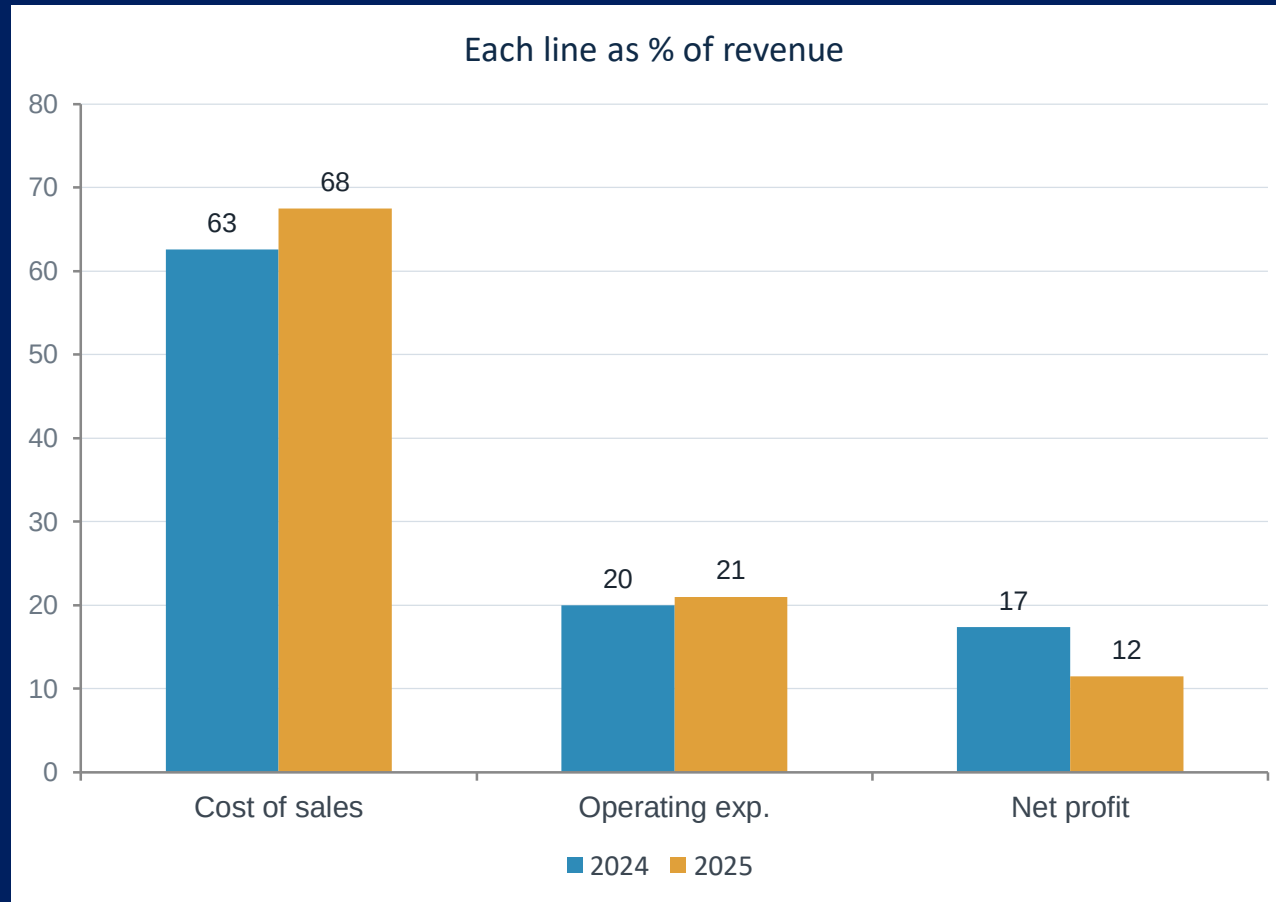
ITEM (€)	2023	2024	2025	Δ 23 → 25
Revenue	100,000	115,000	126,000	+26%
Cost of sales	60,000	72,000	85,000	+42%
Gross profit	40,000	43,000	41,000	+2.5%

INSIGHT

Revenue grew 26% — but cost of sales grew 42%.

*Gross profit barely changed. The business is selling more, but each sale is now far less profitable.
This is the kind of finding trend analysis surfaces in seconds.*

Common Size Analysis - Example



A €1 of sales used to give us 17 cents of profit. Now it gives us 11. The business has become structurally less profitable per euro of sales.

MedCo Ltd - Scenario

MedCo Ltd – Income statement

Medium-sized trading business. Compare 2024 and 2025 carefully — what story do these figures tell?

ITEM (€)	2024	2025	Direction
Revenue	500,000	560,000	▲
Cost of sales	300,000	364,000	▲
Gross profit	200,000	196,000	▼
Operating expenses	120,000	140,000	▲
Operating profit	80,000	56,000	▼
Interest	10,000	18,000	▲
Net profit before tax	70,000	38,000	▼

MedCo Ltd – Balance Sheet

ITEM (€)	2024	2025	Direction
Non-current assets	200,000	260,000	▲
Inventory	60,000	95,000	▲
Trade receivables	70,000	110,000	▲
Cash	30,000	5,000	▼
Total assets	360,000	470,000	▲
Equity	200,000	210,000	▲
Long-term loan	100,000	180,000	▲
Trade payables	60,000	80,000	▲

CASH FLOW HIGHLIGHTS — 2025

Cash from operations +€15,000 • Spent on equipment –€80,000 • New loan raised +€80,000 • Net change in cash –€25,000

MedCo Ltd – Discussion

Q1

Did revenue grow? By how much, in % terms?

Q2

What happened to gross profit, even though revenue grew?

Q3

Why did net profit fall so sharply?



MedCo Ltd – Discussion

Q4 Has the business invested in growth? How can you tell?

Q5 How was the new equipment financed — retained profits, debt, or cash reserves?

Q6 Is the company more or less risky at the end of 2025 than it was a year earlier?



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Turning interpretation into advice

01 OBSERVE

State the fact.
Numbers, not
adjectives.

02 EXPLAIN

Suggest the
likely cause
behind the fact.

03 ASSESS

Judge the
impact in
money or risk
terms.

04 RECOMMEND

Propose a
concrete,
actionable next
step.

Applied to MedCo – Margi Protection

OBSERVE	Gross margin fell from 40% to 35% between 2024 and 2025.
EXPLAIN	Cost of sales grew 21% while revenue grew only 12% — likely supplier price rises or excessive discounting.
ASSESS	A 5-percentage-point drop costs roughly €28,000 of profit at current revenue.
RECOMMEND	Renegotiate top supplier contracts, review the discounting policy, and report monthly margin by product line.

Applied to MedCo – Cash and Liquidity

OBSERVE	Cash dropped from €30,000 to €5,000, while inventory and receivables both grew sharply.
EXPLAIN	Working capital is being tied up in stock and in customers who are paying more slowly.
ASSESS	The business is one bad month away from being unable to pay suppliers.
RECOMMEND	Tighten credit control, set credit limits, follow up overdue invoices weekly, and reduce stock levels of slow-moving lines.



Brief Introduction

To the Ratios

We will spend a full lecture on ratios next session. For now, just understand what they are and why we use them.



What is a Ratio

One number divided by another.

“€56,000 of operating profit”
means little on its own. Compared
to revenue, to assets, or to equity,
it suddenly tells a story.



Why ratios matter

Ratios standardise figures so we can compare across time, across companies, and against industry benchmarks. They turn raw numbers into a language for performance.



The Link Between Decision-Making and Ratios

- **Ratios do not make decisions on their own — they are a diagnostic tool that turns raw financial statements into signals a manager can act on. Every ratio family maps onto a specific type of decision.**



Short-term decisions rely heavily on liquidity and efficiency ratios.

- When a manager is deciding whether to extend credit to a new customer, accept a special order, take an early-payment discount, or cover next month's payroll, they are really asking "do we have the cash and the working capital to do this?" The current ratio, quick ratio, receivables collection days, and inventory turnover are the numbers that answer those questions. In MedCo's case, the cash drop from €30,000 to €5,000 and inventory ballooning to €95,000 are signals telling management to be very careful about any decision that ties up more cash this quarter.



Long-term decisions rely on profitability, gearing, and investor ratios.

- **Should we open a second branch? Take a 5-year loan? Buy that machine?**

These questions need ratios that look at structural health: net profit margin, return on capital employed, debt-to-equity, interest cover. MedCo's rising gearing and weakening interest cover tell you immediately that another major capital decision should probably wait — the business has used up its borrowing headroom.



Three Further Connections

- **Ratios reveal which decision is needed in the first place. A manager who calculates that receivables days have stretched from 50 to 72 did not go looking for a credit-control problem — the ratio surfaced it. Ratios shape the agenda, not just the answer.**
- **Ratios let outsiders make decisions about the business. A bank manager deciding whether to lend, a supplier deciding whether to extend trade credit, an investor deciding whether to buy shares — all of them rely on ratios because they do not have access to internal management information. This is exactly why the exit-ticket question (would you grant MedCo another loan?) works.**
- **Ratios make trends visible. A single ratio in isolation tells you very little; a three-year trend in that ratio tells you whether the business is improving, drifting, or in trouble — and that is the input most decisions actually need.**



The one-line takeaway

Financial statements describe what happened. Ratios translate that description into the language a decision-maker can use. That is the link — and it is exactly what the next lecture will build on.



The five families

Profitability	<i>Are we making enough profit on each sale?</i>
Liquidity	<i>Can we pay our bills next month?</i>
Efficiency	<i>Are assets and working capital used well?</i>
Gearing / Solvency	<i>Are we too dependent on borrowing?</i>
Investor	<i>Is this a good investment?</i>

MedCo Ltd - Scenario

From MedCo's 2025 figures:

- **Net Profit Margin = $€38,000 \div €560,000 = 6.8\%$ (down from 14% in 2024)**
- **Current Ratio = $(95,000 + 110,000 + 5,000) \div 80,000 = 2.6$ — looks healthy on paper, but...**
- **Quick Ratio (excluding inventory) = $(110,000 + 5,000) \div 80,000 = 1.4$ — still OK, but cash alone is only €5,000.**

Class Question

"Imagine you are a bank manager. Based only on what we discussed about MedCo today, would you grant them another loan? Why or why not?"



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