

Contributer's Name

Unknown

Notes Overview

Chapter 13 Study Unit 7 2013/06 Financial Function and Financial Management

Email

info@gimmenotes.co.za
a

School

University of South
Africa (UNISA)

Financial Function and financial Management:

- All businesses need funds. In financial management terms, the word “capital” refers to funds invested in the enterprise. These funds are needed to pay for the required assets, resources and labour.
- The primary objective of the enterprise is often summarised as creating wealth for the stakeholders. The word “stakeholder” refers not only to the owners and/or the shareholders of a business enterprise, but also to the investors of loan capital and, more importantly, the employees of the enterprise.
- Identify the three important tasks which the financial manager must perform in order to carry out his or her duties effectively.

- To contribute to the goal of creating wealth, the financial manager must:
 - cost effectively obtains the funds needed for the enterprise*
 - invest those funds in assets that will give the highest possible return*
 - analyse, plan and control the flow of funds as accurately as possible*

✚ Business must have necessary assets to function efficiently- like :

- Land
- Buildings
- Machinery
- Equipment
- Raw materials
- Trade inventories

✚ Business needs funds –called **capital** to obtain required assets resources and services.

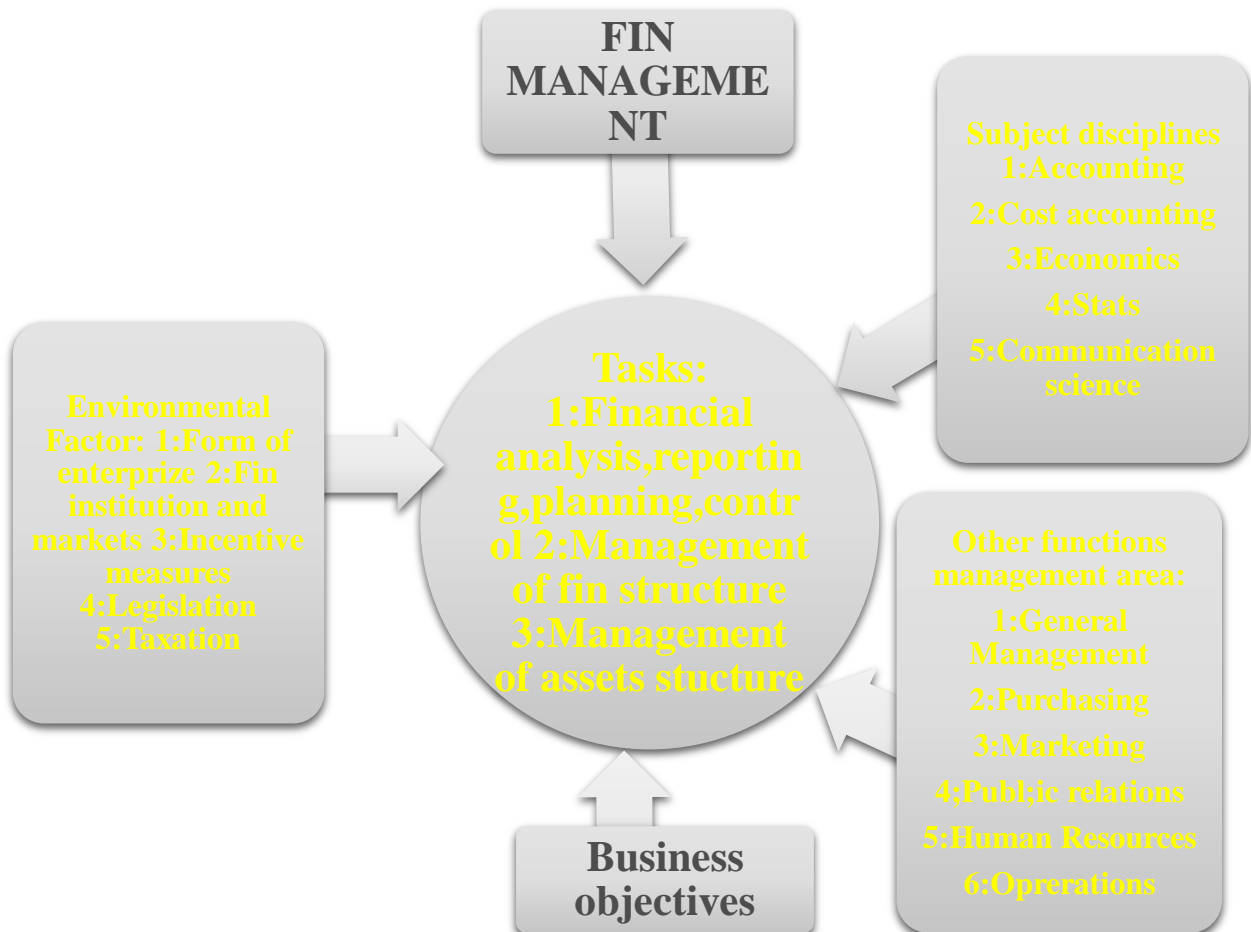
✚ People or institutions that make funds available loose right to use the funds in short and long term.

✚ They stand a chance to loose funds

✚ They expect compensation when organization generate funds

- # Financial function concerned with HOW of funds (*how the fund flow*)
- # Acquisition of funds known as *financing*
- # Application of funds for acquisition of assets known as *investment*
- # Financial management is responsible for efficient management of all facets.
- # Plans of business- make highest contribution to objective through performance of the following tasks:
 - Financial analysis, reporting, planning and control
 - Management of application of funds (*management of assets structure*)
 - Management of acquisition of funds (*management of financing/capital structure*)

FIG 13.1 PAGE 420



CONCEPTS IN FINANCIAL MANAGEMENT:

- ✚ The first (and perhaps the most Important) concept to understand is the balance sheet. Let's draw a balance sheet diagrammatically:
 - There are two major sides:
 - assets on the left,
 - Owner's equity and liabilities on the right.

ASSETS	CLAIMS ON ASSETS	
ASSETS	= LIABILITIES	+ OWNERS' EQUITY
CASH	ACCOUNTS PAYABLE	PREFERRED STOCK
INVENTORIES	WAGES PAYABLE	COMMON STOCK
BUILDINGS	TAXES PAYABLE	CAPITAL SURPLUS
LAND	NOTES PAYABLE	RETAINED EARNINGS
EQUIPMENT	BONDS PAYABLE	
ACCOUNTS RECEIVABLE	INTERMEDIATE TERM DEBT	
MARKETABLE SECURITIES		

PAGE 88 STUDY UNIT fig 1

- ✚ Assets refer to the “possessions” of the enterprise while liabilities refer to the “debts”. Equity refers to the money invested by the owner(s) of the enterprise. Ordinary equity does not have to be paid back to the shareholder at a specified date and no interest on the equity is payable.
- ✚ Assets and liabilities can each be subdivided further: PAGE 88 Study unit fig2
- ✚ Fixed assets (*also called non-current assets*) are long term whereas **current assets are more short term**. Typical current assets are cash inventory (*stock*) and accounts receivable. The expectation is that inventory and accounts receivable will be converted into cash during the next accounting period. In the same way there are long-term liabilities and current liabilities, for example a mortgage bond that is usually repaid over 20 years and bank overdrafts that are paid within a year.
- ✚ Shareholders' funds can be split into ordinary share equity and preference share capital. Owners' equity refers to ordinary shareholding (remember that the ordinary shareholders are the owners of the enterprise), and undistributed profits and reserves. In the balance sheet total assets must always equal equity plus liabilities.
- ✚ Another concept that warrants discussion is that of costs. Firstly, there is the difference between total costs and cost per unit. If an enterprise's total cost is R240 000 and it manufactures 80 000 products (units), then the cost per unit will be $R240\ 000 \div 80\ 000 = R3$. If another enterprise also has a total cost of R240 000, but manufactures only 60 000 units, the cost per unit would be $R240\ 000 \div 60\ 000 = R4$. So to determine the cost per unit you have to divide the total costs by the number of units produced.

- ✚ Secondly, note the difference between fixed cost and variable cost. Fixed cost refers to depreciation, interest, salaries, rent, or lease instalments for example, which will not change regardless of the number of units manufactured and sold. Variable cost refers to the costs which will increase with every additional unit manufactured and sold, for example the raw materials that went into the product and the packaging material. It follows that the greater the number of units manufactured, the higher the total variable cost will be.
- ✚ What about fixed cost per unit and variable cost per unit? If the total fixed cost is R120 000, this will remain the same (“fixed”), regardless of how many units are produced. However, the fixed cost per unit is calculated by dividing the total fixed cost by the number of units. If we manufacture 10 000 units, then the fixed cost per unit will be R120 000 divided by 10 000, which equals R12. If we change the volume of production, say to 20 000 units, the total fixed cost would still be R120 000 but the fixed cost per unit will now be R120 000 divided by 20 000, which equals R6.
- ✚ If it costs R5 to manufacture a unit (eg a chair), then the variable cost per unit will be R5. Whether we manufacture 20 or 200 chairs, the variable cost per unit will always be R5 because it doesn’t change with a change in production volume. However, if we manufacture 20 chairs, the total variable cost will be 20 times R5, which equals R100. If we manufacture 200 chairs, the total variable cost will be 200 times R5, which equals R1 000. So the variable cost per unit does not change with a change in production volume, but the total variable cost will change with a change in production volume.
- ✚ Another important concept to understand is the income statement. The income statement indicates the make-up of the profit or loss for the particular period. Knowing the sequence of the deductions as they occur in the income statement will enable you to calculate ratios accurately at a later stage of the unit’s production (see activity 7.2).
 - *Memorise the sequence of deductions set out in the income statement in figure 13.9.*
- ✚ *Knowing the sequence of these deductions will enable you to calculate the ratios accurately. Refer to activity 7.3 Study guide, in which these calculations will be done.*

1. Concept in financial management

1.1. Balance sheet, asset and financing structure

- ✚ Balance sheet-allows viewer to overall grasp of financial position of a business.
- ✚ Asset side reflects all possessions of business together with the value of business sheet.
- ✚ These assets represent the **asset structure**
- ✚ Assets divided into 2 categories in balance sheet:
 - Fixed assets – land and buildings
 - Current assets – cash in bank, possessions of the business that will convert into cash within one year during normal course of the business.
- ✚ Liability side(**claims side**) of balance sheet reflects nature and extent of interest in assets:
 - Shows financing / capital structure of business
 - Liability side of balance sheet show Financing or capital structure of business as balance sheet date.
- ✚ Liability side Subdivided in 2:
 - Term for which funds were made available
 - Source from which funds have been obtained

- ✚ Liability side of a company will have the following details:
 - Long term funds – noncurrent liabilities, shareholders interest and long term debt
 - Shareholders interest is also subdivided:
 - Owners' equity
 - Preference share capital
 - Long term debt-bonds and loans and long term credit
- ✚ Short term funds – current liabilities, debts and credits payable in one year, eg bank overdrafts and creditors

1.2. Capital

- ✚ Described as accrued power of disposal over the products used by a business to generate monetary return/profit
- ✚ Capital of business described as the monetary value of its assets at a given time
- ✚ Capital needed for investment *in fixed assets* – need fixed capital
- ✚ Capital needed for investment *in current assets* – need working capital
- ✚ Business permanent need for certain minimum portion of working capital.

1.3. Income

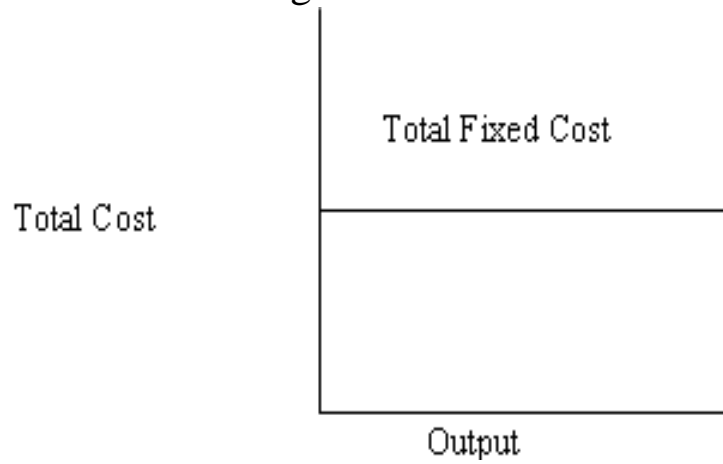
- ✚ Income of a bus consists of receipts resulting from sales of its products and services.
- ✚ Extent of receipt for given period will depend on quantity of product sold within that period and the unit for which they were sold.
- ✚ *Income = units sold x price per unit*
- ✚ Income can also be obtained from interest earned and investment.

1.4. Costs

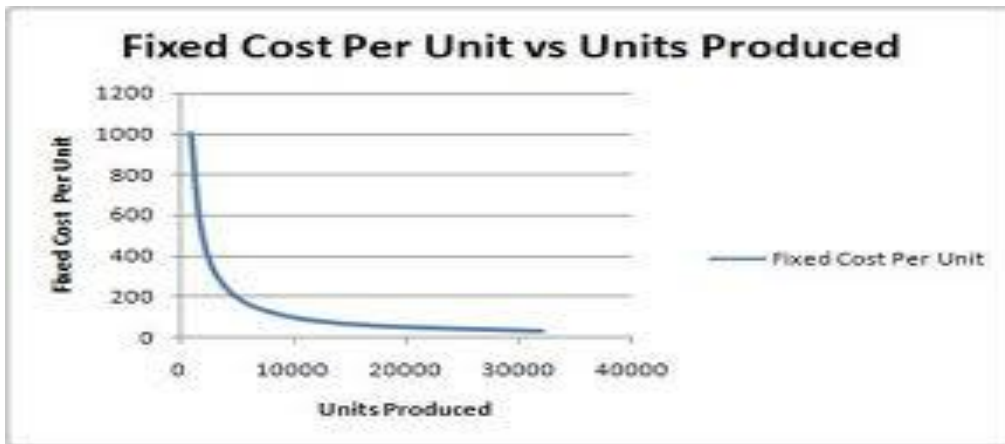
- ✚ Cost can be regarded as monetary value sacrificed in production of product produced for purpose of resale
- ✚ Cost are further subdivided according to certain criteria –*Hence bus has:*
 - Direct costs
 - Indirect costs
 - Overhead expenses
 - Fixed costs
 - Variable costs
- ✚ Subdivisions of total cost into fixed and variables cost is important for making decisions.

1.4.1. Fixed costs

- ✚ Portion of total cost that remains unchanged regardless of increase / decrease in quantity of products or service produce
- ✚ Total fixed cost are constant, irrespective of the volume produced

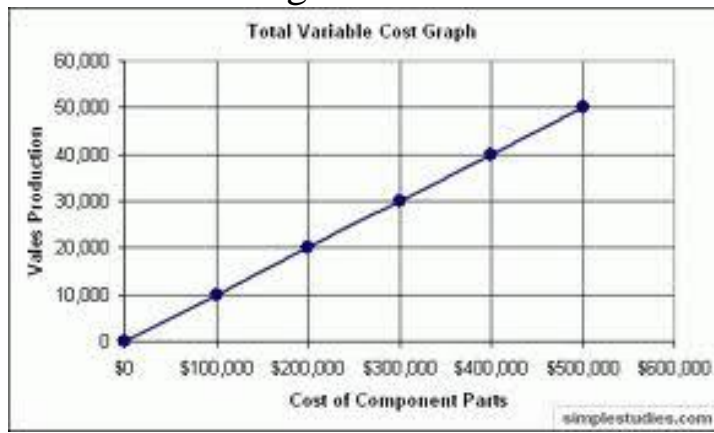


- ✚ Therefore fixed cost per unit produced will **DECREASE** with an **INCREASE** in the **QUANTITY PRODUCED**



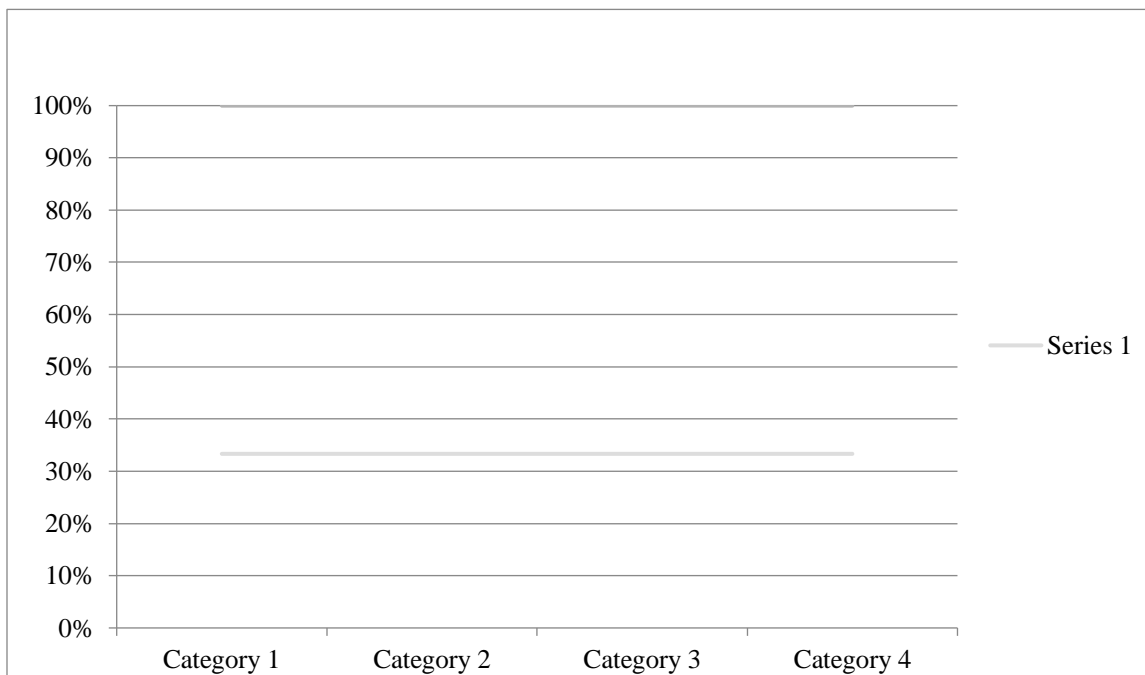
1.4.2. Variable costs

- ✚ Total cost that changes according to a change in volume produced
- ✚ Pure variable cost=manufacturing material cost=because they change in direct proportion to a change in volume produced
- ✚ Other variable cost contain fix-cost component such as a fixed telephone line rental
- ✚ There is no linear relationship between these variable costs and volume produced called semi-variable costs



1.4.3. Variable cost per unit

- ✚ Remain more or less the same irrespective of quantity produced



TOTAL VARIABLE COST PER UNIT

1.4.4. Total cost

- ✚ Total cost involves production of specific number of products produced in particular period consists of total fixed cost and total variable cost incurred in production of products
- ✚ Total fixed cost and total variable cost incurred in production of products.

HOW TOTAL COST ARE ARRIVED AT



1.5. Profit

- ✚ Favorable difference between income earned during specific period and cost incurred to earn that
- ✚ Income
- ✚ Loss results when costs exceeds the income
- ✚ Profit or loss = income – cost
- ✚ OR Profit or loss = (Price x unit sold) - cost

1.6. Income statement

- ✚ Annual financial statement
- ✚ Manner in which profit / loss for specific period was arrived at and has been distributed
- ✚ Statement of financial performance
- ✚ See fig 13.9 on page 427

2. Objective and fundamental principles of financial management:

- ✚ The long-term objective of the business should be to increase its value. This will be achieved by investing in assets that add value and by keeping the cost of capital of the business as low as possible.
- ✚ The short-term financial objective should be to ensure the profitability, liquidity and solvency of the business. Financial management is based on the risk-return principle (the higher the risk taken, the higher the expected return), the cost-benefit principle (discussed in section 7.4 below) and the time value of money principle (discussed in section 7.5 below). Study guide.
- ✚ Long term objective = to increase value of business
- ✚ Can be done by:
 - Investing in assets that will add value to business
 - Keeping the cost of capital as low as possible

- ✚ Short term objective = ensure profitability, liquidity and solvency
- ✚ Profitability = ability to generate income that exceeds cost
- ✚ Liquidity = satisfy short term obligations as they become due
- ✚ Solvency = extent to which assets exceed liabilities
- ✚ Financial management based on 3 principles:
 - Risk return principle
 - Cost benefit principle
 - Time value of money principle

2.1. Risk return principle

- ✚ Profitability that actual result of decision may deviate from planned end result with an associated financial loss
- ✚ Risk is measurable by means of statistical techniques
- ✚ Trade-off between risk and return

2.2. Cost benefit principle

- ✚ To make analysis of total cost and total benefits and ensure that benefits exceed cost

2.3. Time value of money principle

- ✚ Increase the value of money by earning interest

3. Cost – volume – profit relationships:

- ✚ Breakeven analysis can give management valuable insight into the interrelationships of sales volumes and prices, on the one hand, and the fixed and variable costs that constitute the total cost structure of the business, on the other.
- ✚ Breakeven analysis can contribute to the preparation of budgets and setting of targets, and forms the basis for strategic decisions, for example changing the firm's pricing structure or deciding whether future investment should be in capital-intensive rather than labour-intensive facilities. (The former entails higher fixed costs in proportion to the total costs, while the latter entails a higher proportion of variable costs.)
- ✚ The greater a business's fixed costs, the greater its exposure will be to the negative effects of a decline in sales. Fixed costs are related to specific periods and are not influenced by production and sales volumes, whereas variable costs are largely controllable in accordance with changes in production or sales volumes. If, for example, fewer products are manufactured, the total cost of raw materials will also be lower. Breakeven analysis therefore indicates the impact on profits of possible variations in sales volume and/or possible changes in production costs.
- ✚ The key to understanding the concept of the breakeven point is the fact that a business will always have fixed costs even before anything has been manufactured (or any service has been provided). Suppose that a business has a total fixed cost of R100 000. It manufactures computers, and the variable cost per unit is R1 000. The computers sell for R3 000. This means that a variable profit of R2 000 is made on each computer manufactured and sold. If the business manufactures and sells 40 units (computers), it would make a total variable profit of $40 \times R2\ 000 = R80\ 000$. This can also be calculated by taking the total income from sales ($40 \times R3\ 000 = R120\ 000$) and subtracting the total variable cost ($40 \times R1\ 000 = R40\ 000$).

✚ However, since the fixed costs are R100 000, the business would actually be making a loss of R20 000. The question is then: How many units would the business have to manufacture and sell before it breaks even, that is makes no loss? In the above case it is easy to see: the business would have to manufacture and sell 50 units, in order to make a variable profit of R100 000 which would then cover the fixed costs of R100 000. If the business manufactures and sells more than 50 units it would be making an overall profit.

✚ Now let's apply the above figures to the breakeven formula, where N represents the number of units to be manufactured in order to break even:

$$\text{✚ } N = \frac{F}{(SP - V)}$$

$$\text{✚ } N = \frac{100\,000}{(3000-1000)}$$

$$N = \frac{100\,000}{2000}$$

$$N = 50$$

✚ Profitability determined by:

- Unit selling price of product
- Costs of product (fixed and variable)
- Level of activity of business

○ A change in one of these three components will result in change in total profit made

✚ Calculation is referred to - Break even analysis is **total costs is = to total income.**

$$N = \frac{F}{(SP - V)}$$

➤ **N is number of units (volume) no profit or loss made**

➤ **(SP-V) Referred to as marginal income or variable profit.**

4. Time value of money;

✚ The key to understanding this concept is the fact that money changes in value because of interest rates. If you were given the choice of receiving R100 today or R110 in one year's time, which would you choose? The answer depends on the current interest rate that can be obtained. If the current interest rate is 5% per annum, and you accept the R100 today and invest it at 5%, you will earn R5 interest after one year, and you will then have R105. It would therefore be more advantageous to choose the R110 in one year's time. On the other hand, if the current interest rate is 15% per annum, then by investing the R100 today you would earn R15 in interest after one year, giving you R115, and it would therefore be to your advantage to accept the R100 today.

✚ It becomes a little more difficult to calculate if the choice is R100 today or R140 in three years' time, because it is not just a question of multiplying the interest of R5 by 3. This is because after one year you will have R105, and during the following year you will earn interest not on R100 but on R105. So after two years you would have $R105 \times 5\% = R110,25$, and the following year you would earn interest of 5% on R110,25, giving you R115,76. This is known as compound interest. To make it easy to calculate what the future value of a given amount is, we have drawn up some tables. If you look at the future value table in your prescribed book, you will see that there are three columns for three different rates of interest and a number of rows for each year. (Note that such tables can be worked out for every possible interest rate for any number of years, but for study purposes we have limited them to three interest rates for a period of 10 years.)

- ✚ To calculate the future value of R100 after three years if the interest rate is 5%, we would have to multiply R100 by 1,1576 (the factor in the future value table), which comes to R115,76 (the same amount we calculated the long way). Thus taking the R140 in three years' time would definitely be the better option. If the interest rate was 15% then we would calculate R100 times 1,5209, which equals R152,09. In that case it would be preferable to take the R100 today.
- ✚ There is also another way of calculating the time value of money. We can calculate an amount to be received in the future back to its present value. For example, if we knew that we would receive R200 in four years' time, we could calculate what that amount would be worth today if the interest rate were 10%. To make this calculation we now have to turn to the discounting table in the prescribed book. Look under the 10% column. The factor for four years is 0,6830. So if we multiply the R200 by 0,6830 we get R136,60. We can therefore say that an amount of R200 in four years' time is worth R136,60 today.
- ✚ Just to make sure, let's calculate how much an amount of R136,60 today would be worth in four years' time if the interest rate were 10%. Look up the future value factor for 10% after four years. This factor of 1,4641 is then multiplied by R136,60. This gives us R200,00. This confirms that an amount of R200 in four years' time is worth R136,60 today (ie its present value) and, conversely, an amount of R136,60 today will be worth R200,00 in four years' time (ie its future value).
- ✚ You will observe that all the factors in the future value tables are greater than 1, since cash invested now will be worth more in the future. To arrive at this greater future value, the cash invested now must be multiplied by a factor greater than 1. Conversely, the discounting tables all have a figure less than 1, since the value of money to be received at some future time will be less now. Therefore the future value must be multiplied by some factor less than 1 to obtain a reduced sum for its present value.
- ✚ For examination purposes, the discount factors and future value factors will be given, as will the cash flows at various intervals. All you need to know is how to calculate the present and future values. Study guide

Time value of money:

- ✚ Time value of money bears a direct relation to opportunity of earning interest on investment
- ✚ Opportunity rate of return on investment
- ✚ Compounding – process of calculating future values
- ✚ Discounting – process of calculating present values

4.1. Future value of single amount

- ✚ Determined with compounding
- ✚ Interest is added to investment
- ✚ Formula for calculating FUTURE VALUE OF AN ORIGINAL INVESTMENT:
 - $FV_n = PV (1 + i)^n$
 - **PV is original investment or present value of investment**
 - **FV is future value of investment after period**
 - **i. is interest rate per period expressed as decimal number**
 - **n. is number of discrete period over which investment extend**

- In these symbols financial calculations appear:
- $(1+i)^n$ in the formula is known as FUTURE-VALUE FACTOR (FVF) Oor COMPOUND INTEREST FACTOR of a single amount.

4.2. Present value

4.2.1. Present value of single amount

- ✚ Based on principle that the value of money is affected by timing of recipients or disbursements
- ✚ Rate of return that would be forgone by not utilizing the investment opportunity
- ✚ Discounting process is reciprocal of compounding process
- ✚ Important implications of time value money:
 - Inflow must be accelerated
 - Outflow should be delayed
 - Manage inventory as optimally as possible

5. Financial analysis, planning and control

- ✚ When you have worked through this section you should understand why the balance sheet, income statement and funds flow statement are essential sources of information for the financial manager: this data will enable him or her to ascertain the performance and financial soundness of the business – particularly the extent to which owner or shareholder wealth is being maximised over the long term.
- ✚ The financial ratios described in section 13.7.1.5 are useful tools for evaluating a business's financial health. You must know how to calculate these ratios, because they will definitely be asked in the examination.

Question 1

The correct answer is option 3.

First we need to calculate N (number of units sold). From the information given, total fixed costs are R300 and fixed costs per unit are R3. Therefore $N = R300/3 = 100$ units. Therefore alternative a is incorrect, which makes alternatives b, c and d correct.

Let us solve for profit as illustrated below:

$$P = (N \times SP) - [(N \times V) + F] \text{ (section 13.5)}$$

Where:

N = number of units sold

SP = selling price per unit

V = variable cost per unit

$F = \text{total fixed costs}$

$$P = (100 \times R10) - (R600 + R300)$$

$$P = R1\,000 - R900$$

$$P = R100$$

Therefore alternative b is correct.

Let us solve for the number of units to break even, which is $N = F/SP-V$ (section 13.5),

where:

$N = \text{number of units to break even}$

$F = \text{total fixed costs}$

$SP = \text{selling price per unit}$

$V = \text{variable cost per unit}$

Since we have not been given variable cost per unit, we can calculate it by dividing total variable cost by number of units sold, which is $R600/100 = R6$.

$$\text{Therefore } N = R300/R10 - R6$$

$$N = 75 \text{ units}$$

Therefore alternative c is correct.

Let us now confirm alternative d, the marginal income per unit, which is $SP-V$,

where:

$SP = \text{selling price}$

$V = \text{variable cost per unit}$

$$= R10 - R6$$

$$= R4$$

Question 2

The correct answer is option 4.

Alternative a is wrong because the discount rate has the effect of reducing the future cash amount. So if you increase the discount rate (which is always part of the denominator) you increase the denominator. This has the effect of decreasing the present value.

Alternative b is also wrong, because the discounting factor for a certain period and a given interest rate is n is the compound interest factor.

Question 3

The correct answer is option 1.

First, we calculate the value of R3 000 invested on 1 January 2007 as at 31 December 2009 when the account is closed. From the time line we can see that this period is three years.

Therefore $FV_3 = PV (FVIF_{10\% 3})$

= 3 000 (1.3310)

= R3 993,00

We then calculate the value of R1 000 invested on 1 January 2009 as at 31 December 2009 when the account is closed. From the time line we can see that the amount was invested for one year only.

Therefore $FV_1 = PV (FVIF_{10\% 1})$

= 1 000 (1.1)

= R1 100

The value of the combined investment on 31 December 2009 is R3 993 + R1 100 = R5 093. The R5 093 is invested in another account for a period of two years (from 1 Jan 2010 to 31 Dec 2011).

Therefore $FV_2 = PV (FVIF_{15\% 2})$

= R5 093 (1.3225)

= R6 735,49

On 31 December 2011, the person will have R6 735,49 in the account. The correct answer is thus option 1.

5.1. Financial analysis

- ✚ To monitor financial position of organization
- ✚ To limit risk of financial failure
- ✚ To help with financial analysis keep following in mind:
 - Income statement
 - Balance sheet
 - Funds flow statement
 - Financial ratios

5.1.1. Flow of funds in business

- ✚ Business has to make optimum use of limited funds to achieve it's objective

5.1.2. Funds flow statement

- ✚ Helps with analysis of changes in financial position of business between 2 consecutive balance sheet dates
- ✚ Reflects net effect of all transactions for specific period
- ✚ 2 approaches in dividing up funds flow statement
- ✚ According to changes in cash position, incl current bank account
- ✚ Analysis of funds flow statement advantages:
 - Indication of whether cash dividends are justified in terms of cash generated
 - How growth in fixed assets has been financed
 - Indication of possible imbalances in application of funds

- Helps analyze financing methods of business

5.1.3. Financial ratios

- ✚ Liquidity ratio
- ✚ Current ratio
- ✚ Acid test ratio
- ✚ Solving ratio
- ✚ Profitability, rate of return or yield ratio
- ✚ Gross profit margin
- ✚ Net profit margin
- ✚ Return of total capital
- ✚ Return on shareholders interest
- ✚ Return on owners equity
- ✚ Measures of economic value
- ✚ Economic value added EVA
- ✚ Market value added

5.2. Financial planning and control

- ✚ Done by means of a budget
- ✚ Formal written plan of future action
- ✚ Expressed in monetary terms
- ✚ To implement strategy or organization
- ✚ To achieve goals with limited resources
- ✚ Also used for control purposes

5.3. Focal points of budgets in control system

- ✚ Control systems devised to ensure that specified strategic business functions is carried out properly
- ✚ Allocated to responsibility centres:
- ✚ Responsibility assigned to:
 - Income
 - Cost
 - Profit / investment
- ✚ Income centre
 - Outputs are measured in monetary terms
- ✚ Cost centre
 - Inputs are measured in monetary terms
- ✚ Profit centre
 - Measured by difference between inputs and outputs

5.3.1. Integrated system for manufacturer business

- ✚ Operating budget
- ✚ Cost budget
 - Manufacturing cost budget

- Discretionary cost budget
- Income budget
- Profit plan / profit budget
- Financial budget
- ✚ 3 major purposes:
 - Verify viability of operational planning
 - Reveal financial actions to be taken to make execution or operating plans of business will affect future financial actions and condition
- ✚ Capital expenditure budget = expected future capital investment in physical facilities
- Cash budget indicates:
 - Extent, time and sources of expected cash inflows
 - Extent, time and purposes of expected cash inflows
 - Expected availability of cash in comparison with expected need for it.
- ✚ Financing budget = dev to assure the business of availability of funds to meet the budgeted shortfalls of income relative to expenses in short term, and to schedule medium and long term borrowing and financing
- ✚ Budgeted balance sheet = to project how financial position of business will look like at end of budget period.

5.3.2. Traditional budgeting

- ✚ Using actual income and expenditure of previous year as basis and making adjustments for
- ✚ expected changes

5.3.3. Zero based budgeting

- ✚ Look at activities afresh on annual basis
- ✚ Historical results are not used
- ✚ Leads to better prioritization of resource allocation and more efficient business
- ✚ Demoralize managers that have to justify their existence on annual basis

5.3.4. Balanced scorecard approach

- ✚ Introduced by Kaplan and Norton
- ✚ Align department budget with organization vision and mission
- ✚ Strategy implemented from 4 perspectives:
 - ✚ Financial
 - ✚ Customers
 - ✚ Internal processes
 - ✚ Learning and growth

6. Assessment management – management of current assets

- Current assets include:
 - Cash
 - Marketable securities
 - Debtors
 - Inventory

- Over investment in current assets means a low degree of risk
- Causes of profits to be less than maximum because of:
 - Cost associated with capital investment
 - Because of income forgone
- Under investment in current assets increases risk of cash and inventory shortages, also decrease in opportunity cost

6.1. Management of cash and marketable securities

- Cash is money in petty cash drawers
- Costs of handling cash:
 - Loss of interest
 - Loss of purchasing power
- Cost of little or no cash
 - Loss of goodwill
 - Loss of opportunities
 - Inability to claim discounts
 - Cost of borrowing
 - Transaction motive
 - Precautionary motive
 - Speculative motive

6.1.1. Cash budget

- Cash receipts
- Cash disbursements
- Net changes in cash
- Serves as a basis for determining cash needs of a business and indicates when bridging finance will be required

6.1.2. Cash cycle

- Investing cash in raw materials
- Converting raw materials to finished products
- Selling finished products on credit
- Ending cycle by collecting cash

6.2. Management of debtors

- Debtors arise when selling on credit to clients
- Debtors have to settle account in given period
- Credit granted to individual = consumer credit
- Credit sales increase total sales and income
- Balance between amount of credit sales and size of debtor accounts
- 3 important facets:
 - Credit policy
 - Credit terms – credit period and discounts for early payments
 - Collection policy – guidelines for collection
- Realistic credit standards 4 C's
 - Character
 - Capacity
 - Capital
 - Conditions
- Cost of granting debt:
 - Loss of interest
 - Cost associated with determining credit worthiness
 - Administration and record keeping costs
 - Bad debts

6.3. Management of stock

- Includes:
 - Raw materials
 - Auxiliary materials

- Work in progress
- Semi finished products
- Trading stock
- Represent a considerable portion of investment in working capital
- Conflict between profit objective and operation objective
- Costs of handling inventory stock are:
 - Loss of interest
 - Storage cost
 - Insurance cost
 - Obsolescence
- Cost of holding little or no inventory:
 - Loss of customer goodwill
 - Production interruption and dislocation
 - Loss of flexibility
 - Reorder costs

7. Asset management – long term investment decisions and capital budgeting

- Capital investment involves use of funds to acquire fixed assets such as land and buildings
- Benefits accrue over period longer than 1 year
- Long term investments determine type, size and composition of fixed costs
- Importance of capital investment:
 - Relative magnitude of amounts involved
 - Long term nature of capital investment decisions
 - Strategic nature of capital investment projects

7.1. Evaluation of investment projects

- Basic principles is cost benefit analysis
- Benefits and costs occur at different times
- Time value of money should be considered

7.1.1. Cash flow concepts

- 3 cash flow components for capital – budgeting
 - Initial investment
 - Expected annual cash flow over life of project
 - Expected terminal cash flow related to termination of project
- Initial investment
 - Net cash flow outflow of commencement of project at time usually acquisition of fixed assets and required for current assets
- Annual cash flows
 - Net cash flows after tax that occur at any point during life of project minus cash outflow for the year
- Life of projects (in period of years)
 - Economic life of project
 - Determined by physical, technological and economic factors
- Terminal cash flow
 - Expected cash flow after tax which is revealed to termination of project

7.1.2. Net present value NPV and internal rate of return IRR

- NPV and IRR discounted cash flow
- Application of NPV involves:
 - Forecasting
 - Initial investment
 - Annual cash flow

- ☒ Terminal cash flow
- Deciding on appropriate discount rate
- Calculating present values above 3 components
- Accepting all projects with positive NPV

7.1.3. Risk and uncertainty

- ☐ Limitations are that it does not take risk into account
- ☐ Risk = any deviation from expected outcome
- ☐ Uncertainty = unable to id certain variables and unable to assess likelihood of their occurrence
- ☐ Sensitivity analysis take risk into account

8. Financing

- ☐ Entails making decisions about:
 - Types of finance
 - Sources of finance

8.1. Financial markets

- ☐ At any point a financial system consists of those that have a surplus of money and those with shortage
- ☐ Growing business requires funds for new investment or to expand production
- ☐ Financial markets is a channel where “savers” make their money available to those who have shortage thereof
- ☐ Financial institutions act as intermediaries – financial intermediation
- ☐ It is process where financial inst pool money and make it available to business
- ☐ The saver who invests in a business is called financier
- ☐ Financier receives an assets or financial claims in exchange for his money
- ☐ Financial claims can be:
 - Saving and Cheque call accounts
 - Fixed deposits
 - Debentures
 - Ordinary preferred shares
- ☐ Shares referred to as financial securities

8.2. Primary and secondary markets

- ☐ New issues a financial claims are referred to as issues on the primary market
- ☐ Trading of securities after they have been issued takes place in secondary market
- ☐ Saver who needs money can trade claim of secondary market
- ☐ JSE eg of secondary market
- ☐ Tradability of securities ensure that savers continue to invest

8.2.1. Money and capital markets

- ☐ Money market is market for financial instruments with a short term maturity
- ☐ Funds are borrowed and lent overnight or for months
- ☐ Funds required for long term investment are raised and traded by investors on capital market

8.2.2. Types of institutions

- ☐ Financial institutions:
 - Deposit taking institutions
 - ☒ SA reserve bank
 - ☒ Land and agricultural bank
 - ☒ Corporation for public deposits
 - ☒ Private sector banks
 - ☒ Post office savings bank
 - Non-deposit taking institutions

- ☞ Public sector – public investment commissioners
- ☞ Private sector – life assurers, pension and provident fund, short term insurers, trusts
- ☞ Other institutions – industrial development corporation

8.3. Short term financing

- Trade credit
- Accruals
- Bank overdrafts
- Factoring

8.3.1. Trade credit

- Mainly in term of supplied credit
- Supplier does not take payment when prod are purchased
- To ensure payment supplier after offer rebate for early payment
- Has the following advantages:
 - It is readily available for business that pay regularly
 - It is informal
 - More flexible than other forms of short term financing

8.3.2. Accruals

- Most common expenses accrued is wages and taxes
- Accrued tax is also from of financing
- Accruals have no associated cost

8.3.3. Bank overdrafts

- Arrangement with bank that allows business to make payments from Cheque account in excess of balance of account
- Purpose is to bridge gap between cash income and cash expenses
- Usually reviewed annually
- Interest charged daily
- It is repayable on demand – bank can cancel at any time
- Flexible form of short term financing

8.3.4. Debtor finance

- Consist of factoring and invoice discounting
- Sale of debtors to a debt financing company – invoicing discounting
- This company then converts credit sales into cash sales injecting funds that were tied up as working capital
- Factoring = financier also undertakes to collect debt
- The financier to whom the debt is sold = factor
- 2 types:
 - Non-resource factoring
 - Resource factoring
- Non resource factoring – factor buys debtors outright and bears the risk of bad debts
- Resource factoring – seller guarantees that debts are recoverable
- Factoring has the following advantages:
 - Cost of debtor admin is transferred to factor
 - Turnover of current assets increased and less capital is required to finance debtors
 - Liquidity improves
 - More cash available for other purposes

8.3.5. Short term financing decisions

- Cost of short term financing usually lower than long term financing
- 3 approaches:
 - Matching approach
- Hedging approach
- Matching the period for which the finance is obtained with the expected life of

asset

- Fixed assets are financed with long term financing
 - o Aggressive approach
- Uses short term financing that is needed for matching approach
- Permanent current assets are partially financed with short term funds
 - o Conservative approach
- Uses more long term funds than matching approach
- Conservative because it used long term funds that are less risky

9. Long term financing

9.1. Shareholders interest

- Owners equity
- Preference shareholder capital

9.1.1. Owners equity

- Consists of funds made directly available by legal owners in terms of share capital
- As well as indirect contributions in terms of profit retention as reserves and undistributed profits

9.1.2. Ordinary share

- Shareholders are true owners of business
- Shareholders receive share certificates in exchange
- 2 types of ordinary shares:
 - o Par value shares – same value
 - o Non par value shares – value differ
- Co-owner of business has a claim to profits
- Characteristics of ordinary share:
 - o Liability of ordinary share is limited to amount they contributed to business
 - o If business is liquidated they loose their shares
 - o May not be liable for debt
 - o Shareholders have no certainty that money paid for share will be recouped, if depends on success of business
 - o Ordinary shares in a listed company can be traded
 - o Ordinary shareholders are owners of the company
 - o Can vote at general meetings
 - o Voting in proportion to shareholding
 - o Business has not obligation to reward ordinary shareholders in the form of dividends for their investment shares
 - o Share capital is available to company for unlimited time
- Advantages of ordinary shares:
 - o No risk involved because payments of dividends are not compulsory
 - o Additional ordinary shares serves as security for attracting capital
- Retained profits = reserves and undistributed profits
- Advantages:
 - o No issue costs are involved – it is cheaper than using additional ordinary shares
 - o Capital is immediately available
 - o Lends flexibility to capital structure
 - o No control implications
 - o Serves as alternative form of financing
 - o Entails no interest or redemption obligations

9.1.3. Preference shareholders capital

- Falls somewhere between debentures and ordinary shares
- 2 types:

- Ordinary preference share
- Cumulative preference share
- Ordinary preference shareholders forfeit a dividend if directors decide not to declare one in a particular year
- Cumulative preference shareholders retain the right to receive an arrear dividend in following year
- Preference share has following characteristics:
 - It has preferential claim over ordinary shares on profit after tax
 - It has preferential claim over ordinary shares on assets of business in case of liquidation
 - Term of availability is unlimited
 - Authority can vary from full voting to no voting at all
- From viewpoint of business preference shares are cheaper than ordinary shares

10. Long term debt

- Debt that is repayable in a year or more
- Can be obtained by:
 - Loan
 - Credit
- Loan is a contract where borrower undertakes to make interest payment at specific time to lender
- To redeem total amount over a specific period of time
- Supplier of credit provides business (receiver of credit) with power of disposal over an asset and receives extended payments in return, principal sum + interest
- Debentures fixed rate of interest
- Mortgages – fluctuate – variable interest
- In case of unsecured debt creditor does not have preferential claim on assets of business

10.1. Forms of long term debt

- Loans
- Financial leasing

10.1.1. Loans

Debentures

- Most common form of long term debt
- Certificate issued to lender
- Certificate is tradable
- Fixed interest rate
- Available over specified term

Bonds

- Secured loans
- Issued with fixed assets such as fixed property

Registered term loans

- Unsecured loans
- Not freely negotiable
- Loans have advantages:
 - Costs are limited, they are def by loan interest value
 - Interest payment are deductible from tax
 - Control of owners usually not influenced by issue of loans
 - Loans do not dilute earnings of ordinary shares

10.1.2. Financial leasing

- Right to use an asset, legally owned by leaser in exchange for specified rental period

- Financial leasing gives the lessee the opportunity to own asset at the end of the term
- 2 terms:
 - Direct financial leasing
 - Leaseback agreements
- Direct financial leasing
 - Motor vehicles computers
 - Value of asset and interest is paid back with regular installments over period of time
 - Usually linked to life time of asset
 - Maintenance and insurance responsibility of lessee
- Leaseback financing
 - Assets of more permanent nature
 - Assets that a business own is sold to credit supplier and then leased back by business acc to a long term agreement
 - Usually entered into by a business that need to raise funds
 - Business obtains cash without loosing the use of property or equipment
 - Lease payments are deductible from tax

10.2. Sources of financing for small businesses

- Personal funds
- Loans from relatives and friends
- Trade credit
- Loans or credit from equipment seller
- Commercial bank loans
- Small business loans
- Taking in partners
- Selling capital shares
- Venture capital funding

11. Cost of capital

- In capital investment decisions cost of capital serves as benchmark for investment proposals
- In financing decisions various types of capital earmarked for financing the investments of business should be combined so that cost to capital to business is kept to minimum
- Capital structure refers to combination of forms of long term financing and pref shares and debt to finance of a business

11.1. Risk

- 2 components:
 - Possible loss of principle sum
 - Possibility that no compensation will be paid for the use of capital (no interest dividend payments)