Chapter 13 Financial management

1. Concept in financial management 3
1.1. Balance sheet, asset and financing structure 3
1.2. Capital 3
1.3. Income 3
1.4. Costs 4
1.4.1. Fixed costs 4
1.4.2. Variable costs 4
1.4.3. Variable cost per unit 4
1.4.4. Total cost 4
1.5. Profit 4
1.6. Income statement 4
2. Objective and fundamental principles of financial management 4
2.1. Risk return principle 5
2.2. Cost benefit principle 5
2.3. Time value of money principle 5
3. Cost – volume – profit relationships 5
4. Time value of money 5
4.1. Future value of single amount 5
4.2. Present value 6
4.2.1. Present value of single amount 6
5. Financial analysis, planning and control 6
5.1. Financial analysis 6
5.1.1. Flow of funds in business 6
5.1.2. Funds flow statement 6
5.1.3. Financial ratios 6
5.2. Financial planning and control 7
5.3. Focal points of budgets in control system 7
5.3.1. Integrated system for manufacturer business 7
5.3.2. Traditional budgeting 8
5.3.3. Zero based budgeting 8
5.3.4. Balanced scorecard approach 8
6. Assessment management – management of current assets 8
6.1. Management of cash and marketable securities 8
6.1.1. Cash budget 9
6.1.2. Cash cycle 9

6.2. Management of debtors 9
6.3. Management of stock 10

7. Asset management – long term investment decisions and capital budgeting 10
7.1. Evaluation of investment projects 10
7.1.1. Cash flow concepts 10
7.1.2. Net present value NPV and internal rate of return IRR 11
7.1.3. Risk and uncertainty 11

8. Financing 11
8.1. Financial markets 11
8.2. Primary and secondary markets 12
8.2.1. Money and capital markets 12
8.2.2. Types of institutions 12
8.3. Short term financing 12
8.3.1. Trade credit 12
8.3.2. Accruals 13
8.3.3. Bank overdrafts 13
8.3.4. Debtor finance 13
8.3.5. Short term financing decisions 13

9. Long term financing 14
9.1. Shareholders interest 14
9.1.1. Owners equity 14
9.1.2. Ordinary share 14
9.1.3. Preference shareholders capital 15

10. Long term debt 15
10.1. Forms of long term debt 15
10.1.1. Loans 15
10.1.2. Financial leasing 16
10.2. Sources of financing for small businesses 16

11. Cost of capital 17
11.1. Risk 17

- Business needs funds – capital to obtain required assets
- People or institutions who make funds available loose right to use the funds
- They stand a chance to loose funds
- They expect compensation when organization generate funds
- Financial function concerned with HOW of funds
- Acquisition of funds = financing
- Application of funds for acquisition of assets = investment
- To make highest contribution to objective of organization by:
    - Financial analysis, reporting, planning and control
    - Management of application of funds
    - Management of acquisition of funds
- See fig 13.1 on page 420

1. Concept in financial management

1.1. Balance sheet, asset and financing structure

- Balance sheet- overall grasp of financial position of a business
- Assets:
    - Fixed assets – land and buildings
    - Current assets – cash in bank
- Liability side – nature and extent of interest in assets
- Shows financing / capital structure of business
- Subdivided in 2:
    - Term for which funds were made available
    - Source from which funds have been obtained
- Liability side will have the following details:
    - Long term funds – non current liabilities, shareholders interest and long term debt
    - Shareholders interest
        - Owners equity
        - Preference share capital
    - Short term funds – current liabilities, debts and credits payable in one year, eg bank overdrafts and creditors

1.2. Capital

- Accrued power of disposal over the products used by a business to generate monetary return
- 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

- Receipts resulting from sales of it's products
- Income = units sold x price per unit

- Can also be from interest earned

1.4. Costs

- Monetary value sacrificed in production of product produced for purpose of resale
- Direct costs
- Indirect costs
- Overhead expenses
- Fixed costs
- Variable costs

1.4.1. Fixed costs

- Portion of total cost that remains unchanged regardless of increase / decrease in quantity of products produced

1.4.2. Variable costs

- Total cost that changes according to a change in volume produced

1.4.3. Variable cost per unit

- Remain more of less the same irrespective of quantity produced

1.4.4. Total cost

- Total fixed cost and total variable cost incurred in production of products

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

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

- 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

- Profitability determined by:
    - Unit selling price of product
    - Costs of product
    - Level of activity of business
- Break even analysis = total costs is equal to total income

4. 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

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

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 vale 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 a 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 financer
- Financer 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 fianancing

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
    - Aggressive approach
        - Uses short term financing that is needed for matching approach

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

- 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 in 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 deductable 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)