MNB102E

Financial Management (Chapters 17, 18 & 19)

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Financial management function (pg 408)

Financial Manager's Tasks

- **Investment decision-making (chapter 18)**
- **Financing decision making (chapter 19)**

Chapter 17 (Fundamental concepts)

- Fixed asses
- Current assets
- Capital structure
- Shareholder's interest
- Capital
- Working capital
- Income

- Fixed costs
- Variable cost
- Profit
- Income statement

Chapter 17 (Fundamental principles)

- Risk-return principle
- Cost benefit principle
- Time value of money principle
- = = = = = = = = = = = = = = = = = =
- Cost-volume-profit relation
- Financial statements analysis

Fundamental principle, basic concepts (chapter 17)

- **BASIC CONCEPTS**

- ***Balance sheet-*** fixed assets, current assets, shareholders interest, owners equity, long and short-term funds
- ***Income statement-*** income, costs, profit

- **FUNDAMENTAL PRINCIPLES**

- risk-return principle
- cost-benefit principle
- time value of money principle
- analysis of the financial statement

COSTS

- Total fixed cost is constant
- Fixed per unit changes
- Total variable cost changes
- Variable cost per unit is constant

(17.3.4)

Example

- Total fixed costs R25 000
- Sales price per unit R25
- Variable cost per unit R3
- Projected profit R10 000

Continue

Example

- Break-even units (R25 000/(25-R3)=1 136
- Profit per unit R25 – R3 = R22
- Units to make R10 000 profit

  R25 000 + R10 000/(R25-R3)= 1 591units

Example

- **N = F/(SP-V)**
- Total fixed costs =R200
- Total variable costs =R150
- Total sales = R300
- Fixed cost per unit = R2
- **N** = R200/3 – R1.50 =133 units

Time value of money

- Tables will be provided in the exam
- Understand the difference between FV & PV
- Work out the FV & PV of mixed stream of cash flows and notice the differences. (e.g. table 17.11)
- Calculator is allowed but not programmable

Analysis of financial statement

- Income statement

(Learn all accounts in this statement)

- Balance sheet

(Learn all accounts in balance sheet)

Analysis of financial statement

- Why do we analyze the financial statements
- Define each group of ratios
- Practice formulas (they will not be provided in the exam paper)
- Calculate each ratio from the statements

  Be able to improve the performance if the ratio indicate a poor profit

Reasons for analyses

- Profitability
- Liquidity
- Solvency
- Performance
- Sustainability

Define the ratio

- Liquidity ratio refers to the ability of the business to meet short-term obligation
- *(Is the above definition correct?)*

Calculations (example)

- Current ratio
  = Current assets/current liabilities
- Current assets = R4
- Current liabilities = R2
- Current ratio = 4/2 = R2

Interpretation of ratios

- Previous year 10
- Current ratio = 2 → Industry average 5
- Competitor 8
- (NB: the performance is poor. How will you improve it?)

Improving the ratio (performance)

- Profitability ratio
- *For example it can be improved by:*
  - increasing prices
  - increasing production
  - reducing cost

Investment → 18 (Pg 410) Financing → 19

Assets	**Long-term funds**
- Land & buildings	- Shareholders interest
- Plant & equipment	Ordinary share capital
- Vehicles	Preference shares
	- Long-term debt
Current assts	**Current liabilities**
- Cash	- Trade creditors
- Debtors	- Bank overdraft
- Inventory	- Arrear expenses

Investment ↓ 18

Financing ↓ 19

Assets

- Land & buildings
- Plant & equipment
- Vehicles

Current assts

- Cash
- Debtors
- Inventory

Long-term funds

- Owner's equity
- Preference shares
- Shareholders interest
- Long-term debt

Current liabilities

- Trade creditors
- Bank overdraft
- Arrear expenses

CHAPTER 18
Investment management

- Management of current assets
  - Cash management
  - Debtor management
  - Inventory management

Investment in current asset

- OVER-INVESTMENT
- -cost/risk

- UNDER-INVESTMENT
- -cost/risk

Cash management

- Motives for holding cash
- Cash cycle
- Cash Budget

Motives for holding cash

- **Transaction motive**
- **Precautionary motive**
- **Speculative motive**

Cash Cycle

Components of a cash budget

- Cash receipts
- Cash payments
- Net cash

Cash budget (cash receipts)

Details	March	April	May	June
Total Sales	*100*	*200*	*300*	*400*
Cash sales(10%)	10	20	30	40
Collection (90%)		90	180	270
Total cash		**110**	**210**	**310**

Cash budget (cash payments)

Details	March	April	May	June
Total Purchases	*50*	*100*	*200*	*300*
Cash Payments(10 %)	5	10	20	30
Payments(90 %)		45	90	180
Total cash Payments		**55**	**110**	**210**

Cash budget

Details	March	April	May	June
Total cash receipts		*110*	*210*	*310*
Total cash Payments		55	110	210
Net cash		55	100	100
Opening cash		0	***55***	***155***
Cash for the year		55	155	255

Management of Debtors (A/R)

- Type of credit
- Credit policy
- Credit terms
- Collection policy

Type of credit

- Consumer credit
- Trade credit

Credit policy

- Character
- Capacity
- Capital
- Condition

Credit terms

- Discount (3)
- Discount period (10)
- Settlement period (30)
- 3/10 net 30

Collection policy

- Rigorously
- Less rigorously

Cost of credit

- Loss of interest
- Assessment costs
- Administration and record-keeping costs
- Bad debts

Management of inventory

- Profit objective
  - High stock turnover
  - Low stock
- Operating objective
  - Low stock turnover
  - No interruption in production

The cost of holding inventory

- Lost of interest
- Storage cost
- Insurance cost
- Obsolescence

Cost of holding little inventory

- Lost of customer goodwill
- Production interruption dislocation
- Loss of flexibility
- Re-order costs

Management of fixed assets (capital investment) (capital budgeting)

- Importance of capital investment
- -the amount involved
- -strategic nature
- -long-term nature

Capital budgeting

- CASH FLOWS
- -initial investment
- -operating cash flow
- -terminal cash flow

- **How do we use the cash flows?**
- **-**use capital budgeting technique (NPV)

(Question)
NPV TECHNIQUE

- Initial investment of the project is R2000
- Cost of capital is 15%
- Operating cash flows

Year	***Inflows***	***Outflows***
1	R1 000	R 600
2	R1 200	R 800
3	R1 600	R1 000
4	R2 000	R1 300
5	R2 400	R1 600

NPV TECHNIQUE

Year	***Inflows***		***Outflows***		***N/flow***
1	R1 000	-	R 600	=	R400
2	R1 200	-	R 800	=	R400
3	R1 600	-	R1 000	=	R600
4	R2 000	-	R1 300	=	R700
5	R2 400	-	R1 600	=	R800
	R8 200		R5 300		R2 900

NPV TECHNIQUE

Year	Net flows		PVF	PV
1	R400	X	0,8696	= R348
2	R800	X	0,756	= R302
3	R600	X	0,6575	= R395
4	R700	X	0,5718	= R400
5	R800	X	0,4972	= R398
	R2 900			R1 843

- NPV = PV cash flow - initial investment
- NPV = R1 843 - R2 000 = -R153

Investment	Financing
Assets	**Long-term funds**
- Land & buildings	- Owner's equity
- Plant & equipment	- Preference shares
- Vehicles	- Shareholders interest
	- Long-term debt
Current assts	**Current liabilities**
- Cash	- Trade creditors
- Debtors	- Bank overdraft
- Inventory	- Arrear expenses

Chapter 19
Financing decision

- FINANCIAL MARKETS
- FINANCIAL INSTITUTIONS
- FINANCIAL ASSETS

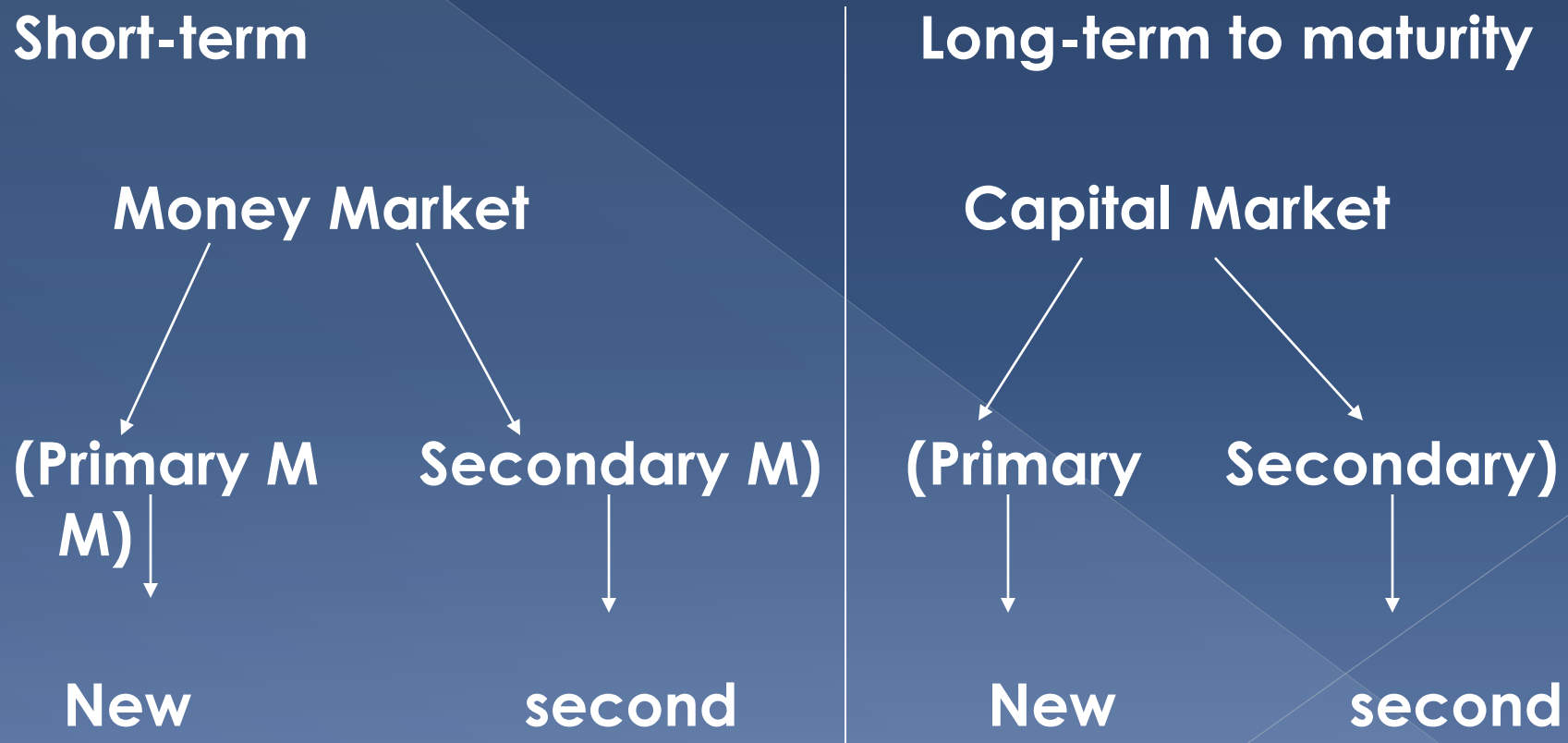
Financial markets

- JSE
- SAFEX
- BESA

Deposit taking institution

- South African Reserve bank
- The land and agricultural bank
- Private sector bank

Financial Markets (define)



Types of institutions (19.2.3)

- Deposit-taking institution
- Non-deposit taking institutions

Investment ↓ 18

Financing ↓ 19

Assets

- Land & buildings
- Plant & equipment
- Vehicles

Current assts

- Cash
- Debtors
- Inventory

Long-term funds

- Owner's equity
- Preference shares
- Shareholders interest
- Long-term debt

Current liabilities

- Trade creditors
- Bank overdraft
- Arrear expenses

Short-financing decision-making

- Risk/cost

Short-financing decision-making

- Trade credit
- Accruals
- Bank overdraft
- Factoring

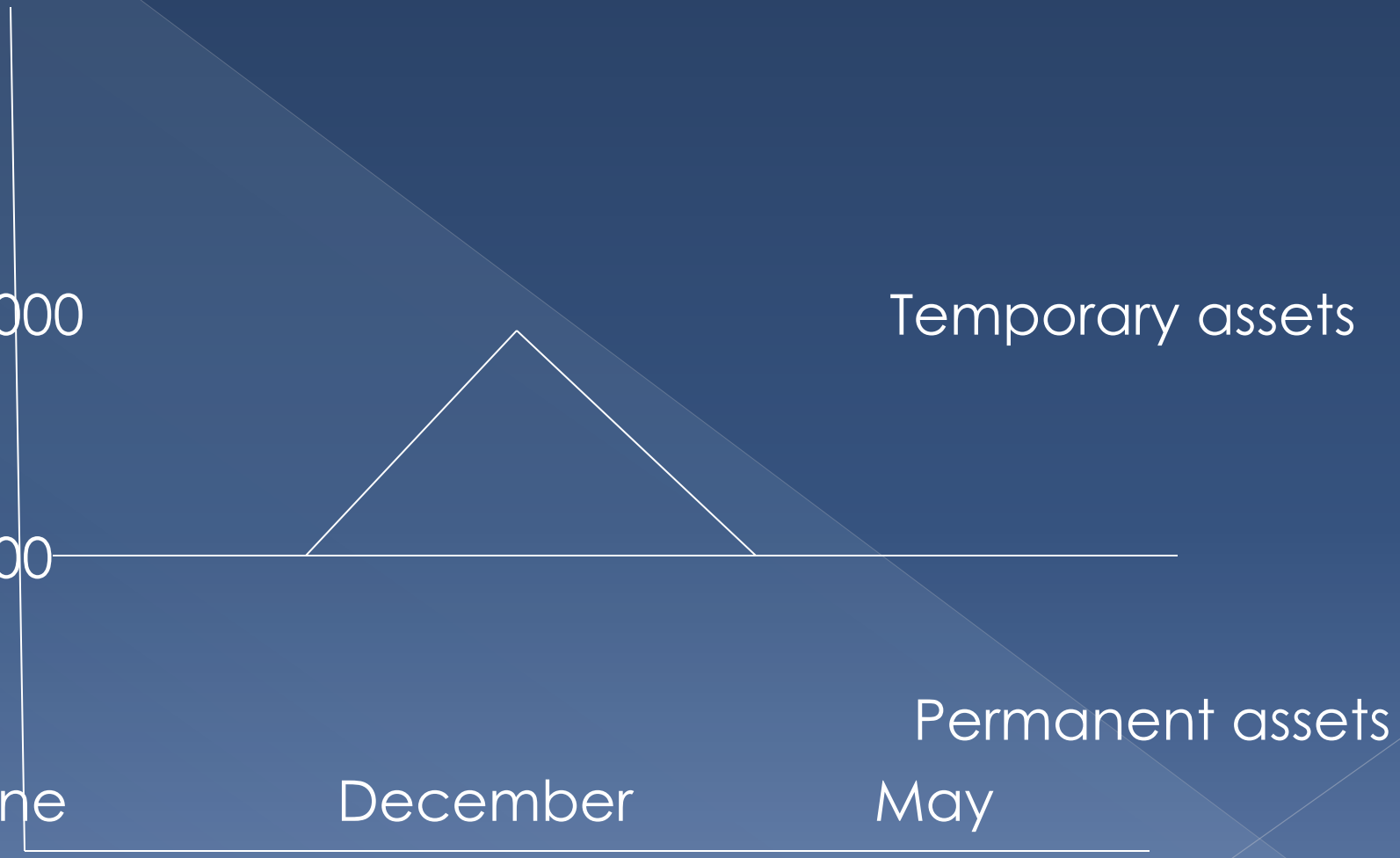
Financing strategies

- Matching approach
- Conservative approach
- Aggressive Approach

Financing strategies

- Seasonal current assets
- Temporary current assets
- Permanent current assets

Funding CCC


14 000
2 000
Temporary assets
Permanent assets
June
December
May

Matching approach

- Fixed assets → Long-term funds
- Permanent current assets → Long-term funds
- Temporary current assets → Short-term funds

Aggressive approach

- Fixed assets → Long-term funds
- Permanent current asses → Long-term funds, Short-term funds
- Temporary current assets → Short-term funds

Conservative approach

- Fixed assets → Long-term funds
- Permanent current assets → Long-term funds
- Temporary current assets → Long-term funds

SOURCE OF LONG TERM FUNDS

- Ordinary shares
- Preference share
- Debt

Shareholders `interest

Ordinary shareholders (Owners` equity) (50%)

Preference shareholders (50%)

Capital structure

Ordinary shareholders (Owners` equity) (50%)

Preference shareholders (30%)

Debt (20%)

Optimal capital structure

	Weight		
Ordinary shareholders	100%	70%	50%
Preference shareholders	0	10	40
Debt	0	20	10

Cost of long term funds

- Weighted average cost of capital (WACC)
- **Form** **Amount** **Weight** **Cost**
- Ordinary R1 400m 20%
  Preference R3 00 000 10%
  Long-term debt R 500 000 9%
- NB: 9% after-tax

Answer

Component	Amount	Cost	Weight	Weighted cost
Owners` equity	1 400	20%	X 63,6	= 12,72%
Preference Shares	300	10%	X 13,6	= 1,36%
Debt	500	9%	X 22,8	= 2.05%
	2 200			
			WACC	16.13

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