role of financial management

- strategic role of financial management
  The strategic role of finance is to manage the financial resources (debt/equity) both efficiently and effectively in order to achieve the triple bottom line.

- objectives of financial management
  - profitability, growth, efficiency, liquidity, solvency
  - **Profitability:** the ability of a firm to generate profit (the difference between revenue and expenses)
  - **Growth:** the ability of the business to increase its size in the longer term.
  - **Efficiency:** is the ability of the firm to use its resources effectively in ensuring financial stability and profitability of the business.
  - **Liquidity:** the ability of a firm to pay its short-term debt obligations as they fall due i.e., overdrafts, accounts payables, inventory purchases, wages and commercial bills.
  - **Solvency:** the ability of a company to meet its long-term financial obligations (MUDL)
  - short-term and long-term

- interdependence with other key business functions
  The marketing, operations and human resources departments rely on financial managers to allocate them adequate funds.
  
  **Ops**
  - requires funds to purchase inputs and carry out their transformation processes
  - relies on operations to produce the products

  **Marketing**
  - requires funds to undertake the various forms of promotion
  - relies on marketing to promote the products

  **HR**
  - requires funds in order to pay for staff
  - relies on HR to manage staff
  *Each of these functions helps the business generate sales and therefore provide income to the finance department.

influences on financial management

- internal sources of finance – retained profits
  The most common source of internal finance is retained earnings or profits in which **all profits are not distributed but are kept in the business as a cheap and accessible source of finance for future activities.** Most businesses keep some of their profit in the form of retained earnings. In Aus. businesses, approx. 50% of profits on average are retained to be reinvested.

- external sources of finance
- debt – short-term borrowing (overdraft, commercial bills, factoring), long-term borrowing (mortgage, debentures, unsecured notes, leasing)
  short term [COF]
  * Commercial bill: money borrowed from other firms looking to earn interest in excess funds not being used – typically over $100,000
  * Overdraft: overdraw an account to a specific limited, paying interest only when account in deficit
  * Factoring: the sale of accounts receivable for a discounted price
  long term [MUDL]
  * Mortgage: loan for property purchases (underlying asset held as security)
  * Unsecured note: a loan that is not secured by the issuer’s asset
  * Debenture: a long term (3-5 yr.) security yielding a fixed rate of interest, issued by a company and secured against assets.
  * Lease: borrowing, contractual agreement to pay lessor over long term for the use of an asset.
- equity – ordinary shares (new issues, rights issues, placements, share purchase plans), private equity
  * new shares (the public)
  * rights issue (existing shareholders)
  * placement (sophisticated investors i.e., banks)
  * share purchase plans (employees)

- financial institutions – banks, investment banks, finance companies, superannuation funds, life insurance companies, unit trusts and the Australian Securities Exchange
  - Banks: retail banks (i.e., commonwealth, NAB) takes deposits from account holders, borrows money from int. money mkt. and lends money to indiv. & busi.
  - Investment banks: merchant banks (i.e., Macquarie Bank, Citibank) provide financial services to the business sector. Provide debt sourcing services for large loans, create debentures, advise merges/acquisitions etc.
  - Financial companies: finance companies act as higher risk bankers
    * Don’t accept deposits
    * Borrow money at low rates
    * Lend on higher rates of interest
    * This interest rate margin generates profits
  - Superannuation funds: Aus. Workers have forced investment accounts that earn returns over decades to fun retirement.
    * Invest in the debt of business (debenture)
    * Shares (equity) of public firms to gain returns for remembers
  - Life insurance companies: providing risk protection to indiv. in case of death or serious injury.
Not many people claim, therefore they create a large pool of funds to invest into equity and debt markets (debentures and shares of large businesses).

- **Unit trusts**: an investment vehicle through which member can contribute funds to purchase assets to gain a return.
- **ASX**: share market operator for the trading of securities
  * Primary market: new shares
  * Secondary: sale and purchase of pre-owned shares.

**Influence of government – Australian Securities and Investments Commission, company taxation**

- Australian securities and investments commission (ASIC)
  * Enforces and administers the corporation’s acts and protects consumers in areas of investment, life and general insurance, superannuation and banking.
  * Ensures all companies adhere to the law, collects info about companies → makes available to public.
  * Impact on profitability; compliance costs (expense) which increase as regulation around an industry increases
- Company tax – tax paid on net profit
  * Was 30% but decreasing slowly in 2021-22 aiming for 25%
  * Impact on profitability; expenses

**Global market influences – economic outlook, availability of funds, interest rates**

- Economic outlook – forecast of expected eco. Conditions worldwide – impacts on decisions made by businesses and individuals.
  * **Positives**: businesses willingness to take risks and pursue growth, consumers increase D 4 g/s (*businesses require funds to meet this D*), finance is easier to obtain (*decrease risk due to increase D*)
  * **Negatives**: consumer demand slows, finance is harder to obtain (*and more expensive due to uncertainty*)
- Availability of funds – willingness of investors to lend money...is linked to global outlook, though it can be also influenced by domestic economy/resources
  * Investors (*banks, financial institutions, other companies, high net worth indiv, govt*) willingness to take risks and invest money dependant on *current and future market* conditions.
  * **Positives**: high levels of business and consumer confidence → less risk in lending $$$, more likely to lend money (*more availability*), more likely to invest in equity (*increase availability*) and cos to borrow money is lower (*IR*)
  * **Negatives**: low confidence levels → perceived risk in lending $$, less likely to lend money (*decrease availability*), less likely to invest in equity (shares) (*decrease availability*), cost to borrow money is higher (*IR*)
- Interest rates – the cost of borrowing $$ is linked to the availability of funds and the eco outlook.
* Rates set by RBA
* **Positive economic outlook:** high levels of business and consumer confidence → less risk in lending money → cost to borrow $$ is lower (IR)
* **Negative economic outlook:** low confidence levels → perceived risk in lending money → cost to borrow $$ is higher

**processes of financial management**
- planning and implementing – financial needs, budgets, record systems, financial risks, financial controls
  * Financial needs – inflows>outflows, more money coming in than out
    > Financial information includes balance sheets, income statements, cash flow *statements*, sales/price forecasts, budgets, bank statements, weekly reports, break-even analysis
    > Determined by – size of business, current phase of the business cycle, future plans for growth and development, capacity to source finance (debt and/or equity), management skills for assessing financial needs and planning
    > Business plan may be used when seeking finance or support for a project from a bank or investors, these institutions must ensure that financial commitment will result in success – types of info in business plan depends on audience (employees, owners, lenders, investors) – needed to show that a business can generate acceptable return on investment sought
  * Budgets
    > Provide information in *quantitative terms* about requirements to achieve a particular purpose
    > Budgets show – *cash required for planned outlays* for a particular period, cost of capital expenditure and associated expenses against earning capacity, estimated use and cost of raw materials or inventory, number and cost of labour hours required for production
    > Reflect strategic planning about resource use and provide info about goals and are used in strategic, tactical, and operational planning
    > Enable constant monitoring of *objectives* and provide a basis for administrative control, sales effort, planning, price setting, stock control, expenses, and production cost
    > Used in both *planning and control* – control measure, planned performance can be measured against actual performance and corrective action taken as needed
    > Budgeting must consider – review of past figures and trends, gathered estimates, potential market/market share, trend, seasonal fluctuation, proposed expansion or discontinuation of projects,
proposals to alter price/quality, current orders, plant capacity, considerations from external environment (financial trends, availability of materials and labour)

* Record systems
  > Mechanism employed by business to ensure that data is recorded and info provided by record systems is accurate, reliable, efficient, and accessible
  > ASIC – poor record keeping is major cause of business failure
  > **Minimising errors** in recording process and maintaining accurate financial statements important – double entry system of accounting is an important control aspect (record all items twice, entries seen to balance, and checks to find errors can be carried out quickly)
  > ATO legal requirement to keep certain records for min. of 5 years
  > **Financial statements** – revenue statement, balance sheet, cash-flow statement

* Financial risks
  o Risk to a business of being unable to cover its financial obligations (debts incurred through borrowing) – if this occurs bankruptcy will result
  o In assessing financial risk, consider – amount of business’s borrowings, borrowings are due to be repaid, interest rates, required level of current assets needed to finance operations
  o If business financed from borrowings – higher risk – greater expectation of profits/dividends
  o To minimise risk, business consider amount of profit to be generated – must cover debt and justify risk – also consider liquidity of assets, short-term debt it must have liquid assets so debt including interest and repayment of principal on loans are covered

* Financial controls
  > Most common cause of financial loss/problems – theft, fraud, damage or loss of assets, errors in record system
  > **Theft/fraud** – unnecessary over purchase of stock for personal use, conflict of interest, misuse of expense accounts, false invoices theft of inventory/assets, or credit card fraud
  > Financial controls – **policies and procedures** that ensure that the plans of a business will be achieved in the most efficient way
  > Policy/procedure must be followed by both management and employees – control important in assets such as accounts receivable, inventory, and cash
  > Common policies that promote control – clear authorisation and responsibility for tasks in the business, separation of duties, rotation
of duties, control of cash, protection of assets, control of credit procedures (follow up overdue accounts and customer credit checks)

- debt and equity financing – advantages and disadvantages of each

- matching the terms and source of finance to business purpose
  - monitoring and controlling – cash flow statement, income statement, balance sheet
    - Cash flow statement
      > indicates movement of cash receipts and cash payments resulting from transactions over a period of time
      > Users of the statement – creditors, lenders, owners, shareholders, potential shareholders
      > Better predictor of status that profitability, whether a firm can –
        - Generate favourable cash flow ratio
        - Pay financial commitments when they fall due
        - Have sufficient funds for growth/change
        - Obtain external finance
        - Pay drawings to owners or dividends
      > Activities of businesses are divided into 3 categories –
        - Operating activities = cash in/outflows relating to main business activity. Y from sales plus dividends and I received. Outflows consist of payments to suppliers, employees, and general operating expenses
        - Investing activities = cash in/outflows relating to purchase and sale of NCA and I, used to generate Y for business
        - Financing activities = cash in/outflows relating to borrowing activities of the business. Inflows relate to equity or debt,
outflows relate to repayment, dividends, or cash drawings (of owner)

> Usually prepared from income statement and balance sheet. ONLY CASH TRANSACTIONS

* **Income statement** (statement of financial performance)
  > summary of the Y earned, and the expenses paid *over a period of time*
  > Statement shows:
    - Operating Y earned from the main function of the business, i.e., sales of inventories, services, and non-operating revenue earned from other operations such as interest, etc.
    - Operating expenses i.e., purchase of inventories, payment for services and other expenses incurred in the main operation of the business
    - GP = SALES REVENUE – COGS
    - NP = COGS – EXPENSES

* **Balance sheet** (statement of financial position)
  > Represents business’s assets and liabilities *at a particular point in time* and represents the net worth (equity) of the business
  > Shows level of C/NC Liabilities/assets
    - Asset – items of value. Current can be turned to cash within 12 months, non-current greater than 12 months
    - Liabilities – claims against assets, representing what is owed by the business
    - Owners’ equity – funds contributed by the owner, represents net worth of business
  > Analysis indicates – assets to repay debts, assets being utilised to maximise profits, owners making good return on investments
  > Accounting equation – relationship between assets, liabilities, and owners’ equity
    - Assets = Liabilities + Owners’ Equity

- **financial ratios**
  - liquidity – current ratio (current assets ÷ current liabilities)
    - a ratio showing the dollar amount of current assets to every $1 of current liabilities
    - balance sheet
    - compare to - accounting convention 2:1
    - should a business have **greater than 2:1**, it may **not be using its cash effectively** in terms of growth. **Highly liquid**
    - should a business have **less than 2:1**, it may find it **difficult to meet its short-term financial commitments** as they fall due. **May not have enough cash on hand**
gearing – debt to equity ratio (total liabilities ÷ total equity)
  - a ratio showing the dollar amount of debt to every $1 of owner’s equity
  - balance sheet
  - compare to – 1:1
  - greater than 1:1, it may find it difficult to repay its long-term debts as they fall due and therefore be required to sell off assets. Highly geared
  - Less than 1:1, it should not have any difficulties in repaying its long-term debts are they fall due and may take the opportunity to take on more debt to grow the business. Adequately geared

profitability – gross profit ratio (gross profit ÷ sales); net profit ratio (net profit ÷ sales); return on equity ratio (net profit ÷ total equity)

* Gross profit ratio – income statement
  - showing the dollar amount of GP earned on every $1 of sales
  - level of mark up a firm has on its financial output; the difference between COGS and revenue; how much profit is generated from good sold.
  - the higher the ratio the better shows efficiency of COGS
  - lower results indicate narrow profit margins
  - ↑ GP = COGS ↓ or sales ↑
  - ↓ GP = COGS ↑ or sales ↓

* Net profit ratio – income statement
  - Showing the dollar amount of NP earned on every $1 of sales
  - Shows how profitable a firm is after COGS and all other expenses have been deducted from revenue
  - Shows overall performance of business
  - The higher numbers are better for a firm
  - Lower results indicate firm is struggling to cover all expenses
  - ↑ NP = expenses ↓ or GP ↑
  - ↓ NP = expenses ↑ or GP ↓
  - Budgeted figures = “predicted” figures

* Return owner’s equity ratio – income statement (NP) and balance sheet (OE)
  - Show the dollar amount of NP earned on every $1 of owners invest. funds
  - Shows effectiveness of business to generate a profit using money invested by owners *sales management, COGS “ “, op exp “ “
  - The higher the ratio the better hopefully ↑ overtime
  - Favourable results may encourage additional investment
  - Higher # better for owners
  - If return compares favourable → owners may consider expansion or diversification of the business
  - If return is unfavourable → owners would consider alternative options, including selling off the business
- efficiency – expense ratio (total expenses ÷ sales), accounts receivable turnover ratio (sales ÷ accounts receivable)

* expense ratio – income statement
  o a ratio showing the amount of expenses to every $1 of sales or %
  o track costs i.e., wages
  o higher expense ratios may be the result of poor management

* account receivables ratio – income statement and balance sheet
  o STEP TWO = 365 DAYS / X (FOUND IN STEP 1)
  o The number of days it takes to collect accounts receivables
  o < 30 days = efficient
  o 40 or more days = less efficient
  o ↑ efficiency = ↑ profits and financial stability

- comparative ratio analysis – over different time periods, against standards, with similar businesses

  • limitations of financial reports – normalised earnings, capitalising expenses, valuing assets, timing issues, debt repayments, notes to the financial statements

* normalised earnings; adjusted to take into account changes in the eco. Cycle or remove one off or unusual items that will affect profitability – done to give more accurate depiction of the true earnings of a company. i.e., floods, or bushfires

* capitalised expenses: where business records an expense as an asset on the balance sheet rather than an expense of the income statement – underrates expenses and overstates profits as well as the assets of the business i.e. research and development, development expenditure, delivery truck as to buy petrol.

* Valuing assets; process of estimating the value of assets when recording them on a balance sheet i.e., goodwill (reputation), house (dep/appreciation of value)

* Timing issues: the matching principle → expenses incurred by a business must be recorded on income statement for the accounting period which the revenue is earned. i.e. real estate agent sold property June, received 2% commission but employer did not pay them till July. This expense SHOULD be recorded in June

* Debt repayments: gearing ratio used to determine whether businesses are at risk of meeting long term financial commitment. A business that is highly geared may be alarming for some stakeholders. Cane be limited because don’t always have capacity onto disclose specific info

* Notes to financial statement: any changes must be noted at end of financial reports

• ethical issues related to financial reports
  Audited accounts
  * All private and public companies are required to have their accounts audited (checked)
  * Auditing is a process designed to establish the truth and fairness of the financial reports
* Conducted by independent accountants who check samples, chosen at random, to ensure the overall accounts are accurate

Inappropriate cut
* Profits need to be matched with the costs and revenues that generated that profit.
* If done dishonestly or incompetently and the cut-off period is inappropriate, the reports will give a false impression.

Misuse of Funds
* The misuse of funds refers to a range of dishonest and illegal practices.
* Systems and procedures should be put in place to prevent fraud.

financial management strategies

• cash flow management
  - cash flow statements
  - distribution of payments, discounts for early payment, factoring
    o discounts for early payments — offer debtors opportunity to receive a discount if they pay their account early increasing cash, liquidity and decreasing cost to consumer.
    o Factoring — sell accounts receivables to factoring businesses at discounted price hence original current assets total is now actually worth less.

• working capital management
  - control of current assets — cash, receivables, inventories
    o ↑ CA by —
      ▪ Selling NC assets and lease them back
      ▪ Distribute its ongoing payments to retain cash
      ▪ Manage inventory to ensure not waste and protect inventory to reduce/eliminate theft
      ▪ ↑ cash by taking on debt
      ▪ ↓ spending on capital equipment or infrastructure to retain cash
  - control of current liabilities — payables, loans, overdrafts
    o accounts payables by — paying early is a discount is offered by creditor or wait till end of payment period to pay off debt (hold onto cash for as long as possible.
    o Loans – monitor costs of establishment, IR, ongoing fees
    o Overdraft by – monitoring est. costs, fees, IR and withdrawal limit
  - strategies – leasing, sale and lease back
    o sell and lease non-current assets

• profitability management
  - cost controls – fixed and variable, cost centres, expense minimisation
    o fixed and variable, expense minimisation - reducing costs
- fixed costs remain same irrespective of business activity i.e., salaries and rent
- variable costs change proportionally to business activity i.e., wages, utilities usage
- cost centres – creation of separate cost accounts for divisions/units i.e., breaking costs by dep. And tracking over time

- revenue controls – marketing objectives
  elements of 4ps to ensure firm minimises revenue and profits pricing policies
  - too high – fewer sales (at higher margins)
  - too low – higher sales (at narrow margin without covering firm expenses)
  - reviewing sales (product) mix
  - changing the products/services
  - diversitising: new lines
  - maximising profits: remove products

- global financial management
  - exchange rates
    * as countries have their own currency, they use for domestic purposes it is this dom. currency that business seeking M must use to pay for their purposes
    * therefore, in all global transactions it is necessary to convert the currency to the domestic currency to enact payment
    * the foreign exchange market (forex) is the ratio of one currency to another
    * effects of currency fluctuations:
      * an appreciating A$ - makes Aus. X $ ↑ ↓ sales ↓ profits
      * a depreciating A$ - makes Aus. X cheaper → ↑ sales ↑ profits
  - interest rates
    * as a business expands overseas or domestically it will normally need to raise finance from domestic or international lends
      o whilst o/s IR may be lower than in Aus, a business needs to take into account fluctuations in ER when assessing whether to loan money from an international lenders as repayments need to be made in a foreign currency. The ER fluctuations may negate the IR savings.

- methods of international payment – payment in advance, letter of credit, clean payment, bill of exchange
  * to reduce risk associated w/ payment for goods/shipping goods across the globe, there are 4 different forms of payments
  * methods of trust payments.
    o payment in advance – exporter receives payment first then sends the goods. This is what happens when you shop online. No risk for exporters but higher risk for importers
- clean payment – *exporter ships goods directly to the importer first*, then the importer pays. Risk for exporter not receiving payment, no risk for importer

* methods of payment third party
  - letter of credit – *bank to bank commitment* – bank acts as a middleman. Bank has buyers funds and issues a letter of credit (which guarantees payment) which will be sent to the exporter once they provide proof of shipment. Essentially bank holds onto the money until tracking info is provided for the goods. Risk for exporter not receiving payment is low but delayed. Risk for importer low risk no receiving good but bank fees
  - bill of exchange – exporter sends goods and a letter requesting payment however, the exporter legal ownership over the goods until payment has been made. Risk for exporter equal risk for importer equal.

- Hedging
  - A way of protecting oneself against financial loss or other adverse circumstances i.e., safeguard, protect or shield
  - Derivative contracts can be used to hedge financial exposure. Hedging refers to the practise of reducing or fully eliminating the risk associated with holding an unstable assets
  - Natural hedging: establish offer shore subsidies (establish company in another country so all transactions undertaken in their dom. currency. Arrange for M
  - Hedge-process which minimise risk associated with international trade (exchange rates, interest rates)
  - A hedge can be thought as a type of insurance. A premium is paid to protect a company from negative outcome
  - Normally done using complex financial instruments known as derivatives

- Derivative
  - Financial instruments used to reduce exporting risk.
  1. Forward Exchange Contract
     * Contract to exchange one currency for another at an agreed rate at an agreed time
     * Usually 30, 90 or 180 days
  2. Options Contract
     * Gives the buyer the right to buy or sell currency at future time
     * No obligation
     * Buyer - option holder
  3. Swap Contract
     * Contract to swap currencies on the spot with an agreement to reserve the transaction in the future
     * Allow domestic and foreign companies to take advantage of their good credit rating at home