Higher Still Notes

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Higher
Business Management

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Unit 2
Outcome 3

Contents

Finance

What is Financial Management?

Financial management involves the *planning*, *organisation*, *co-ordination* and *control* of an organisation's credit facilities, cash and other assets.

Why is Financial Management Important?
- To control costs to maximise profits and prevent bankruptcy
- To ensure that an organisation has enough cash to survive
- To establish and control profitability
- To ensure that adequate funds for buying the resources needed to achieve objectives are available.

What is Required for Effective Financial Management?
Like all other areas of management, effective management of finance will come from informed decision-making.

Financial information for informed financial decision-making will be provided by:

- Financial reports – trading, profit and loss accounts; balance sheets
- Financial report analysis – ratio analysis
- Cash flow statement – preparation and analysis
- Budget preparation and analysis.

Limits of Financial Statements that may affect Decision-Making
- Variations in international accounting standards can cause differences and so information may be inaccurate and decisions incorrect
- Some values are subjective, e.g. stock, intangibles (goodwill) etc, and so information nay be inaccurate and decisions incorrect
- Information is historic, has no logical bearing on the future or future decisions
- Information is only based on *quantifiable financial* data, and so decisions taken can have ignored important factors, such as:
  - Morale/staff turnover
  - Product portfolio
  - Abilities/skills/experience of staff
  - Research and development/new product development
  - Competition
  - Market size and share
  - Organisation structure
  - Marketing strategies/techniques
  - Social concerns/duties.

Who will be Interested in an Organisation's Financial Management and Performance?

Internal users
- Managers (to record, analyse, evaluate and control)
- Owners (to evaluate their investment return and worthiness)
- Employees (wage bargaining)
- Trade unions (wage bargaining).

External users
- Potential investors (return on capital employed for investment decisions)
- Creditors (credit worthiness)
- Lenders (credit worthiness)
- Government (tax/VAT)
- Economists (research data)
- Competitors (comparison/information)
- General public/media ("externality" policies).

Financial Reporting and Financial Statements

Financial reporting involves recording all of an organisations activities during a trading period, usually one year, and communicating them in an understandable and summarised way as financial statements.

The most common types of financial statements are:

- The *trading, profit and loss accounts*
- The *balance sheet*.

Together these statements are known collectively as the final accounts.

The Trading, Profit and Loss Accounts
This is a historical review of the revenue (i.e. money in) and expenditure (i.e. money out) of an organisation during a previous trading period, in order to determine the *profit* or *loss* which resulted from the period's activities.

This account is made up of two main parts:

- The *trading section* of the account calculates how much *gross profit* the organisation has generated *directly* from the buying and selling of goods and services
- The *profit and loss* section of the account calculates how much *net profit* the organisation is left with after it has deducted the *expenses* (i.e. general running costs of the business) from the *gross profit*.

Key areas of the trading, profit and loss accounts include:

- Sales or turnover
- Cost of sales
- Gross profit or loss
- Expenses
- Net profit.

The Balance Sheet

A balance sheet shows at one specific point in time:

- The assets (valuable resources which are owned), liabilities (amounts owed to others), and, in turn, total value of an organisation
- The make-up of the equal amount of equity (sources of finance) which has been used to generate this value.

Key areas of a balance sheet include:

- Fixed assets
- Current assets
- Current liabilities
- Net current assets (working capital)
- Net assets (net worth)
- Issued share capital (Ltd/PLC)
- Opening capital
- Profit
- Reserves
- Drawings (sole trader/partners)
- Long-term liabilities.

Financial Statement Analysis – Ratio Analysis

Although financial statements can be used to provide straightforward information about the progress and worth of an organisation, they can also be analysed to provide other important, but less obvious, information about:

- Current performance relative to previous performances (intra-firm)
- Current performance relative to that of competitors (inter-firm)
- Why performance changes and to improve in the future
- Bases for forecasting or budgeting.

This other information is provided through the use of *ratio analysis*, which highlights the trends in:

- Profitability (profit relative to spending)
- Liquidity (ability to pay liabilities)
- Efficiency (how well resources are being used).

Although the information ratio analysis provides is useful for all of the above, there are some limitations to its use:

- Accounting information used is historical and so can be irrelevant to the future
- Like must be compared with like (e.g. size, product, etc.)
- Findings may not take into account important external factors
- Different stock valuation methods can result in different figures.

Profitability Ratios

Gross Profit Margin (expressed as a percentage)
This measures the percentage of profit earned on the trading activities of an organisation. Improvement is a positive sign which will be due to increased sales/selling price or falling trading costs, and vice versa.

$$\frac{Gross\ Profit}{Sales\ (turnover)} \times 100\%$$

Profit Mark-Up (expressed as a percentage)
This measures the percentage added to trading costs in order to arrive at the selling price. Improvement is a positive sign which will be due to increased sales/selling price or falling trading costs, and vice versa.

$$\frac{Gross\ Profit}{Cost\ of\ Goods\ Sold} \times 100\%$$

Net Profit Margin (expressed as a percentage)
This measures the percentage of overall profit earned after all expenses have been accounted for. Improvement is a positive sign that will be due to decreased expenses, and vice versa.

$$\frac{Net\ Profit}{Sales\ (turnover)} \times 100\%$$

Current (Working Capital) Ratio (shown as a ratio)
This checks to see if current assets will cover current liabilities. A minimum ratio of 1 : 1 is usually needed. Improvement of this ratio is a positive sign when it comes from better use and control of credit (i.e. quicker repayments from debtors/longer credit terms/less use of creditors) and banking. However, if this ratio simply improves because of increased stock holding, this can signal a problem. Holding large quantities of stock can be ineffective in terms of money (direct and opportunity costs) and wastage.

Current Assets : Current Liabilities (or CA : CL)

Acid-Test Ratio (shown as a ratio)
This checks to see if *liquid* current assets (i.e. current assets which can be easily converted into cash) can cover current liabilities, or if there is going to be a cash-flow problem in the near future. Stock is therefore taken out as it can sometimes be hard to sell and so a poor source of cash. A minimum ratio of 1 : 1 is usually needed, with improvement a positive sign which shows better use and control of credit and banking.

Current Assets – Closing Stock : Current Liabilities

Efficiency Ratios

Return on Capital Employed (expressed as a percentage)
This measures the percentage return ("rate of interest" earned on the capital invested. Improvement is a positive sign that will be due to better use of invested capital in the generation of profit.

$$\frac{Net\ Profit\ (before\ interest\ and\ tax)}{Capital\ Invested} \times 100\%$$

What is a Budget and what is it Useful For?

A budget is an agreed plan (in terms of money, cash flow, units produced/sold etc.) for a specific period of time in the future, e.g. a month/year.

Budgets are set and used to direct, monitor and control organisational activities through the process of budgetary control.

Budgetary control refers to the process of:

• Setting budgetary targets (directing)
• Reviewing actual performance against budget (monitoring)
• Identifying differences between the budget and the actual amount (monitoring)
• Identifying reasons for any differences between the budget and actual amount
• Taking constructive action on the basis of these findings (controlling).

Budgets and budgetary control are important and useful for managers' fulfilment of their roles as follows:

• Decision-making (it provides information)
• Planning (by looking ahead and setting targets)
• Informing (providing actual information versus budgeted information)
• Organising (planning the use of organisational resources)
• Commanding (identifying and setting staff targets and actions)
• Coordinating (making sure all staff work to the same budget/goal)
• Controlling (through accountability for monitored work done)
• Delegating (allowing others to work without losing control)
• Motivating (encouraging staff to try to attain targets).

However, steps must be taken to make sure that budgets do not become unobtainable or too far from actual performance as these situations will prevent the budget motivating staff or providing any meaningful information.

What is Cash Flow and why is it Important?

All organisations need efficient cash flow (i.e. enough money coming in to pay the bills and provide funds for goal achievement), if they are to survive and succeed.

This is the case, because even profitable organisations can fail if they simply do not have enough cash to pay their bills or allow for development due to some of the following reasons:

• Overtrading (too much production, too little capital)
• Over-investment in fixed assets
• Stock piling
• Allowing too much credit
• Taking too much credit
• Over-borrowing
• Underestimating inflation
• Unforeseen expenditure
• Unexpected changes in demand
• Seasonal factors.

This efficient cash flow will be achieved through using the information on *cash budgets* and *cash flow statements* to make informed decisions about *sales*, *purchases* and *credit*.

Cash Budgets (Future Analysis of Cash)

A cash budget is a budget which aims to help the cash flow management of an organisation by showing its' cash flows over a future period of time and so highlighting any upcoming surpluses (i.e. extra cash) or deficits (i.e. shortages of cash).

Cash budgets are useful as they allow management to:

- Plan the use of surpluses for the best return – e.g. purchasing new assets or investments
- Plan and implement the financial arrangements necessary to deal with, prevent, and minimise any deficits. This would include arranging overdrafts, selling off stock, extending credit terms, cutting back on investment, etc.
- See the impact and implications of any major decisions or policies on cash flow before they are implemented.

Key areas of the cash budget are:

- Opening balance
- Income (added to the opening balance)
- Total funds for the time period
- Expenses (taken away from the total funds)
- Total expenses.

Cash Flow Statements (for the Past Analysis of Cash)

This is an accounting document that aims to help the cash flow management of an organisation by showing the impact its activities have had on its cash flow during the past financial year.

These are useful because they clarify for management the changes in the actual cash position of their organisation rather than accountant-defined profits or working capital, which do not truly reflect the cash position of the organisation due to timing issues and accounting procedures.

Key areas of a cash flow statement are:

- Opening balance
- Income (added to the opening balance)
- Total funds for the period
- Expenses (taken away from the total funds)
- Total expenses
- Closing balance.