TOPIC 3: FINANCE

Two key parts of the syllabus do not ignore any of them!

Students learn to:

Skills - what you have to be able to do in the HSC

- Explain
- Analyse
- Identify
- Compare
- Calculate
- Assess
- Recommend
- Examine

- Case studies:
  - Actual
  - Contemporary
  - Hypothetical

Students learn about:

Content - what you have to know and understand in the HSC

- Role of Financial management
- Influences on Finance
- Processes of Financial management
- Financial Managament Strategies

ROLE OF FINANCIAL MANAGEMENT

WHAT IS FINANCIAL MANAGEMENT?

Financial management is the planning, monitoring and controlling of a business' financial resources (funds, money, all things of value) to enable the business to achieve its goals.

Financial management will involve tasks such as:

- Determining the business' financial needs in the long and short term
- Raising finance
- Budgeting the cash flow
- Monitoring the financial performance (profitability, liquidity, etc.)
- Writing reports (Balance Sheet and Revenue Statement)
- Auditing
- Credit control
- Payments
- Investing
- Analysing costs

Strategic Role of Financial Management

Strategic planning is the big picture and answers questions such as:

- Where will the business be in 3 – 5 years?
- How will the business get there?
- What markets will the business be in?

The role of finance is to make sure that the business can realise this vision by providing adequate financial resources.

The strategic plan is the long-term plan of the business – looking at where the business is going and how it plans to get there. The strategic plan must encompass all the strategies that a business will use to achieve its goals as well as a means to track the success of the plan – monitoring and controlling.

It is critical to business success that businesses plan and monitor their financial situation – to ensure that business objectives are being met.

Strategies are the steps the business will adopt to achieve its goals in the short term and the long term. Strategies for monitoring the monitoring financial resources are incorporated into the strategic plan and will include:

- Monitoring cash flows
- Paying debts
- Interpreting financial reports
- Developing financial controls
- Auditing accounts and making profits

OBJECTIVES OF FINANCIAL MANAGEMENT

Objective	Definition
Profitability	Earnings of the business from its operations. Shown in the revenue statement as net profit.
Growth	The increase in value of the business over time. Shown in the Balance Sheet as the value of total assets.
Efficiency	Another word for the productivity of financial assets. If a business is efficient it will be using its assets to make profit at the lowest possible cost.
Liquidity	This is a short-term objective relating to the ability of the business to meet its cash commitments.
Solvency	A longer-term objective. It indicates the level of borrowing in the business and will affect the ability of the business to access funds in the future.

SHORT-TERM AND LONG-TERM FINANCIAL OBJECTIVES

Short-term financial objectives are contained in the tactical (1-2 year) and operational (day to day) plans e.g. to buy a new machine so that production can be more efficient to meet profit goals for the year.

Long-term financial objectives are contained in the strategic plans of the business and are determined for a set period of time e.g. to achieve 10% market share by the end of 2018.

Many business objectives complement each other and meet me at the needs of a broad range of stakeholders. However, sometimes-potential conflicts rise between short-term and long-term financial objectives.

For example a common financially long-term objective is growth. The decision to expand would have the support of managers, employees, supplies the community and the economists. However expansion is often associated with increased costs and gearing (i.e. borrowing money) which relates to lower short-term profits. This decision may therefore cause conflict with the business owners, shareholders as well as investors.

However, in the long run most business owners would be pleased to support an expansion if it increases the overall value of the business.

The conflict between short-term V long-term results is critical in business. This is because in order to achieve long-term profitability businesses need to invest in capital (physical) and human resources. Many of these resources cost money and take a long time to pay off, therefore minimising the businesses ability to meet their short-term obligations.

Reconciling these conflicting goals is not always easy and managers who adopt the short-term thinking run the risk of impacting long term risks, which may lead to lower profits and lower growth. Financial managers must constantly assess the achievement of specific objectives and attempt to satisfy as many goals as possible.

QUESTION
Examine ONE potential conflict that arises between short and long term financial objectives?

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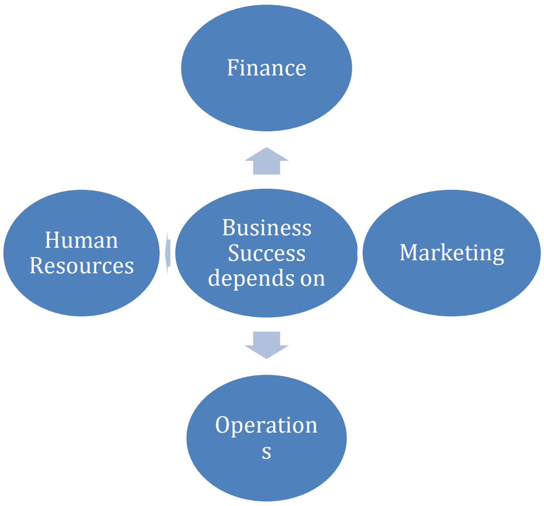
INTERDEPENDENCE WITH OTHER KEY BUSINESS FUNCTIONS



All the business functions are interdependent – which means that each function (finance, marketing, human resources and operations) must interact with all the others to achieve the goals of the business.

Financial management involves:

- Budgeting
- Financing
- Financial analysis
- Financial reporting

And makes it possible to hire employees, purchase machines and supplies and finance marketing so that the business can achieve its objectives with respect to: liquidity, profitability, efficiency and growth.

Clearly the finance function is critical since it is the function that ensures that the resources are on hand to achieve all the other objectives – but financial management must be adapted to the different stages of the business life cycle.

Masters Hardware – Financial Failure

(a) http://www.smh.com.au/business/retail/is-this-masters-store-the-most-shortlived-retail-outlet-in-history-of-shopping-20160119-gm9bef.html

(b) http://www.smh.com.au/business/retail/what-went-wrong-at-woolworths-masters-20160118-gm8fge.html

QUESTION
What financial problems could a business face if the marketing function fails to meet the sales targets in the business' budget?

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Use the information below to answer Question 1.

The financial manager of a gift shop business has decided that improving the turnover of accounts receivable is a goal for the coming year.

1. Which of the following objectives of financial management are they addressing?

   A Solvency and liquidity
   B Profitability and liquidity
   C Growth and profitability
   D Liquidity and efficiency

2. At times financial objectives of business will conflict with each other.

   Which two financial objectives are least likely to conflict?

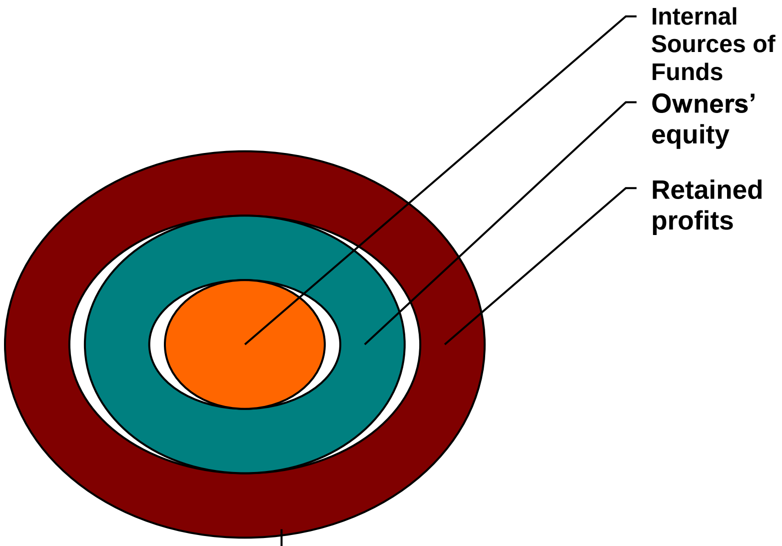
   A Efficiency and profitability
   B Growth and solvency
   C Liquidity and profitability
   D Profitability and growth

3. Which of the following provides the best indicator of a business' long term financial stability?

   A Expense ratio
   B Current ratio
   C Gross profit ratio
   D Gearing ratio

INFLUENCES ON FINANCIAL MANAGEMENT

SOURCES OF FUNDS



Equity

- Ordinary shares
- New issues
- Rights issues
- Placements
- Share purchase plans
- Private equity

EXTERNAL SOURCES OF FUNDS

Short-Term

- Overdrafts
- Commercial bills
- Factoring

Long-Term

- Mortgage
- Debentures
- Unsecured Notes
- Leasing

- Internal sources – retained profit. This is the profit that the business keeps and does not give to the owners (shareholders). It is an influence because the greater the availability of retained profit the less the business needs to borrow and the better its solvency.

- External sources. These are sources that the business accesses from outside i.e. not retained profit. These sources can be debt or equity. They are an influence because they have different costs associated with them and therefore affect financial efficiency and profitability.

- Debt sources – must be repaid with interest (usually but not always). Can be short term (repaid within 1 year and are current liabilities) or long term (paid back over a term longer than a year and are non-current liabilities. These are an influence because they impact on LIQUIDITY.

- Equity sources – these are funds that come from owners (new or existing) and are commonly raised through selling shares on the primary market. These are an influence because they affect SOLVENCY (debt:equity)

You will need to know the definitions of these terms. How many do you know already?

SHORT TERM

Overdraft:

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Commercial Bills:

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Factoring **(think about this one for a second – Is it really a debt instrument?)**

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LONG TERM

Mortgage:

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Debentures:

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Unsecured Notes:

Leasing:

EQUITY

Ordinary Shares:

New issues:

Rights issues:

Placements:

Share purchase plans:

Private Equity:

Venture – Capital

FINANCIAL INSTITUTIONS

Why are financial institutions an influence on financial management?

Because they lend to business at different cost (interest) and for different purposes so a financial manager must seek the correct and most cost effective way of borrowing.

For each of the following institutions you must know its role in business finance. They are all mentioned in the syllabus and could be the subject of a multiple-choice question in Section I of the examination.

Institution	Role in business finance
Bank	Credit cards, overdrafts, mortgages Main supervisor/regulator = APRA (Australian Prudential Regulatory Authority) e.g. – NAB, Westpac, CBA, ANZ, St George, Citi Bank, HSBC
Investment bank	Deal with companies and offer investment advice, money market dealings and arrange long term, project, and overseas finance. E.g. Macquarie Bank, ING, ABN AMRO Australia Ltd, JP Morgan.
Finance company	Non-bank. Involved in leasing assets E.g. AGC, GE Finance, Esanda Finance
Superannuation funds	Long-term debt and equity due to nature of their funds. E.g. MLC, HESTA Super Fund, CBUS, AGEST
Life insurance companies	Large equity or debt finance
Unit Trusts	Invest funds on behalf of clients.
Australian Securities Exchange	Primary market for equity and secondary market for investing. Also debt funds through debentures.

ROLE OF THE AUSTRALIAN STOCK EXCHANGE (ASX) AS A PRIMARY MARKET

Initial Public Offerings (IPOs) are a key vehicle for incorporated companies to increase their capital in the form of equity financing. Billabong floated on the ASX in 2000 for an initial capital of $600 million.

ASX acts as primary market, this enables company to raise new capital through issue of shares and through receipts of proceeds from sale of securities.

Also operates as secondary market, where pre-owner or secondhand securities, such as shares, traded between investors (individuals, businesses, governments, financial institutions).

GOVERNMENT INFLUENCES

ROLE OF AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION (ASIC)

This is a 'watchdog' and enforces the Corporations Act 2001. Its role is to protect consumers by reducing fraud and unfair practices in companies.

Overview:

- Independent statutory commission but accountable to Commonwealth parliament.
- Protects consumers in areas of investment, life and general insurance, superannuation, banking (except lending).
- Ensures companies adhere to law.
- Collects info about companies and makes available to public (incl. financial info disclosed in annual reports).
- Supervision of retail investments industry.
- In 2010 assumed responsibility for supervision of trading on Aust.'s domestic licensed equity, derivatives and futures markets.

COMPANY TAXATION

The company tax rate is 28.5% of net profit for businesses that have a turnover of $2 – $10 million as of 1st July 2016. This was announced in the 2016/17 Federal Budget. For all other cooperate entities the tax rate is still 30%. However, the government is aiming to reduce this rate over the next few years. This is an influence because companies might decide to relocate to other parts of the world where the tax rates are lower.

GLOBAL MARKET INFLUENCES

The syllabus identifies three global market influences on financial management and you need to be able to describe the influence and explain how it influences financial management in an Australian business.

Global Market Influences

- Financial risks associated with global markers > domestic risk and volatility.
- Risk = necessary for business strategy to be implemented.
- Largely uncontrollable financial influences = availability of funds, interest rates, global economic outlook.
- 'Uncontrollable' means → influences are part of external business environment and may not be significantly controlled by business.
- Business can put in place appropriate financial management strategies to minimise negative effects.
- Globalisation has created more interdependence between economies, businesses and the financial sector, which relies on trade for expansion and increased profits. Contagion effects.

Global Economic Outlook

- Refers specifically to projected changes to level of economic growth throughout world.
- If the global outlook is positive, this leads to an increase in world economic growth and positive impacts on financial decisions of business. This may include:
  - Increasing demand for products and services → businesses need to increase production to meet demand → require funds to purchase equipment, employ/train staff, expand business size.
  - Increased domestic and global interest rates.
  - If the lookout is negative the opposite of the above occurs.

Availability of Funds

- Refers to ease with which business can access funds for borrowing on international financial markets. When making such decisions businesses need to take into account the level of AUD against foreign country and interest rates (see interest rates).

- International Financial Markets are made up of range of institutions, companies and governments prepared to lend money to individuals, companies, and governments.

- Various conditions and rates that apply based primarily on:

  - Risk
  - Demand and supply
  - Domestic economic conditions

Interest Rates

- Cost of borrowing money.

- Higher level of risk in lending = higher interest rates.

- Traditionally Australian interest rates are higher than other countries (US and Japan).

- Australian businesses may borrow finance overseas to take advantage of lower interest rates.

- Risky as exchange rate moves.

- Adverse currency fluctuation can diminish the advantage of cheaper interest.

PROCESSES OF FINANCIAL MANAGEMENT

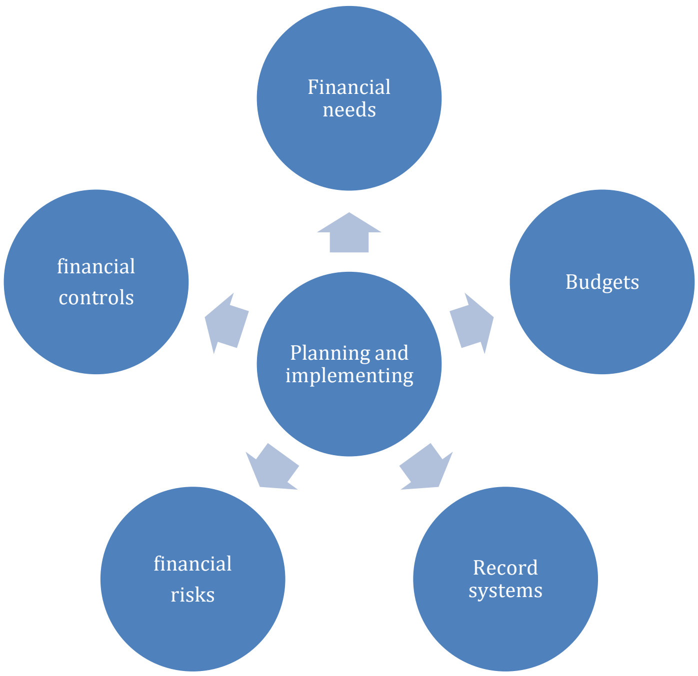
PLANNING AND IMPLEMENTING

Financial planning is about making certain that the business has sufficient funds to meet its future requirements in the short and long term.

Financial planning is essential if a business is to achieve its goals. The financial planning process begins with strategic financial plans that include capital expenditure and planned investments. Capital expenditure is what is spent on a businesses non-current assets in order to generate revenue.

Long term plans also cover planned sources of finance, spending on R & D, marketing & product development.

The diagram below shows the elements of the financial planning and implementation process:



Financial needs:

- In order to determine where a business s headed it is important to know where it is positioned now – financial information must be collected before future plans can be made e.g. balance sheets, revenue statements etc.

- The financial needs of the business depends on its size, phase of the business cycle, future plans for growth, capacity to source finance, management skills to assess financial needs.

- Business plans should include detailed financial information including revenue and cash flow statement, balance sheet, financial ratios analysis etc.

- Financial information is needed to show that the business can make an acceptable return on the investment being sought from a creditor.

Developing Budgets:

- Budgets provide information in quantitative terms (facts/figures) about requirements to achieve a particular purpose.

- Budgets can be drawn up to show: cash required for planned outlays, cost of capital expenditure and associated expenses against earning capacity, estimated use and cost of raw materials or inventory, number and cost of labor hours required for production.

- Budgets enable constant monitoring of objectives and are used in both the planning and controlling aspects of a business. Budgets can be used to measure planned performance versus actual performance and then corrective action taken as needed.

- Budgets are important in the planning process and various factors needed to be considered when preparing it include: review of past figures or trends, estimates from departments, potential market or market share, expansion or discontinuation of projects, current orders or plant capacity

Record systems:

- Record systems are the mechanisms employed by an organization to ensure that data are recorded and the information provided by record systems is accurate, reliable, efficient and accessible.

- In maintaining record systems, it is important to minimize errors and always provide accurate and reliable financial statements – double entry system of accounting.

Minimising financial risks:

- **Financial risk** is the risk to a business of being unable to cover its financial obligations e.g. debts through short or long-term borrowing.

- Questions relating to financial risk include: Borrow to expand? Should excess funds be used to purchase assets or invest in the short-term money market, rising interest rates? Changing exchange rates?

- In assessing financial risk for a business consideration must be given to: the amount of the organisation's borrowings, when borrowings are due to be repaid, interest rates, the required level of current assets needed to finance operations.

- To minimise risk, businesses must consider the amount of profit generated – the profit must be sufficient to cover debts as well as to justify the risk taken by owners/shareholders.

Financial controls:

- The most common form of financial problems include: theft, fraud, damage to assets, errors in the recording system.
- Financial controls are the policies and procedures that ensure that the plans of an organization will be achieved in the most efficient way.
- Control is particularly important in assets such as accounts receivable, inventory and cash. Procedures that promote control in an organization include: clear authorisation and responsibility for tasks, separation of duties (ordering and receiving), rotation of duties, control of cash (e.g. cash banked daily, no money kept on premises overnight, payments made by cheque, not cash), protection of assets, control of credit procedures such as following up overdue accounts and customer credit checks.
- Budgets and variance reporting are financial reports used in business.

QUESTION
This is the type of question you could get in the HSC Section II – the short answer section...

Explain how budgets and record systems can be used to reduce financial risk. (4 marks)

COMPARISON OF DEBT AND EQUITY FINANCING

The mix of debt and equity used to finance business operations is termed 'gearing'. There are industry variations but generally the mix will be 50:50. It is becoming increasingly difficult obtaining funds from banks without very strong financial commitments from its owners.

High levels of gearing raise concerns about a firm's solvency and ability to repay the Debts (particularly since the Global Financial Crisis). If gearing levels are too low the business may be a target for takeover by raiders seeking to grow the business via debt financing (more difficult in last 12 months). High debt levels have precipitated the global financial crisis. The financial community are very concerned with the high level of debts; and the fact these may not be repaid by the debtors (i.e. bad debts). High financing and refinancing costs due to increased interest rates has seriously impacted highly leveraged institutions in terms of their rising expenses, lower profitability and their reduced desirability as an investment option.

Many questions in the HSC examination have been about comparing debt and equity financing.

	Debt	**Equity**
Advantage	• Funds readily available if lending criteria met • Interest is a tax deduction • No sharing of increased earnings and profit that flows from the investment of borrowed funds	• Does not need to be repaid • Can be cheaper (not always) • Lower risk and exposure due to lower gearing • No reduction in solvency
Disadvantage	• Financial risk from interest rate rises • May require mortgage over assets • Regular payments may cause liquidity issues • Lenders are creditors and may affect working capital	• Sharing of gains and profit with equity partners • Usually more expensive due to high expectations of return for equity partners

FINANCIAL CONSIDERATIONS

MATCHING SOURCES OF FUNDS TO BUSINESS INVESTMENTS?

The matching principle ensures that short-term assets are matched to short-term liabilities, whilst long-term assets are matched to long-term liabilities and/or owners' equity. This is crucial to the effectiveness of financial management.

For example:

- Emissions trading consultancy – venture capital, grants.
- Small Café – overdraft, business loan, leasing, mortgage.
- Large company – initial public offering (IPO): equity.

Recommend a type of finance for the following scenarios:

1. A security business mainly does government contracts at schools and hospitals. The government is slow to pay accounts and the business is having a cash flow problem, experiencing difficulty paying its expenses including a large wages bill each month.
2. A very large business listed on the stock exchange wishes to raise a large amount of finance to fund a major upgrade in technology. The business is concerned about its low share price on the ASX.
3. A retailer of toys needs to order and pay for Christmas season stock in June.
4. A small business in the electrical trades needs to purchase a new vehicle as it is employing an additional tradesman.
5. A business in fashion retail wishes to expand by opening up in a new premises that has become available for purchase.
6. A highly profitable business wishes to fund an innovative new product launch.
7. A small business is engaged in a government contract and will be paid on completion, but needs cash to fund the work required to complete the contract. The sum required is around $150,000 and the term is 6 months.
8. A catering business is having difficulty paying its food suppliers cash. Many of its customers are corporate accounts who pay on a 30 day invoice.

MONITORING AND CONTROLLING

You need to be able to analyse three different financial statements and understand the relationships that exist in them:

THE CASH FLOW STATEMENT

CLOSING CASH = OPENING CASH + (CASH RECEIPTS – CASH PAYMENTS)

Remember:

- The cash flow statement only includes actual cash items. If you have to calculate a cash balance in the HSC multiple choice section it will include non-cash items to put you off!
- If the closing cash is a negative number then the business is said to have a cash **deficit** and it will need to get cash from another source.
- If the closing cash is a positive number the business is said to have a cash **surplus,** which is shown as a current asset in the Balance Sheet.

Have a go at this:

Calculate the cash balance for this business at the end of June 2014.

	$
Cash balance at 31/05/12	5000
Sale of goods on credit	15000
Cash sales	5000
Receipts from debtors	10000
Purchase of goods on credit	8000
Payments to creditors	3000
Wages paid	4000
Rent	3000
Electricity	2000
Advertising	3000
Sale of motor vehicle	1000
Net profit	1500

Answer: ____________________________

THE REVENUE STATEMENT (STATEMENT OF FINANCIAL PERFORMANCE)

The revenue statement explains how the business made its profit for the accounting period (usually one year.) It shows how much the business sold. How much it purchased and what expenses it incurred.

GROSS PROFIT = SALES – COST OF GOODS SOLD (COGS)

COGS = OPENING STOCK + PUCHASES – CLOSING STOCK

OR

COGS = OPENING STOCK + PUCHASES + FREIGHT IN – CLOSING STOCK

NET PROFIT = GROSS PROFIT – EXPENSES

REVENUE STATEMENT SAMPLE

		$
Sales		210 000
Cost of Goods Sold		
Opening Stock	40 000	
Purchases	63 000	
Closing Stock	13 000	90 000
Gross Profit		120 000
Expenses		
General & Admin Expenses	16 000	
Selling & Distribution Expenses	50 000	
Financial Expenses	6 000	
Net Profit		48 000
Additional Information:		
Gross Profit Ratio 2014 - 75%		
Net Profit Ratio 2014 – 30%		

THE BALANCE SHEET (STATEMENT OF FINANCIAL POSITION)

The Balance Sheet shows the financial position of the business. It shows what it **OWNS** (assets) and what it **OWES** (liabilities and equity).

A = L + OE

BALANCE SHEET SAMPLE

Assets	$	Liabilities	$
Current Assets		**Current Liabilities**	
Cash	20 000	Overdraft	45 000
Inventory	65 000	Accounts Payable	145 000
Accounts Receivables	110 000		
		Non Current Liabilities	
Non Current Assets		Mortgage	140 000
Equipment	30 000		
Vehicles	45 000	**Owners Equity**	
Goodwill	55 000	Retained Profit	120 000
Buildings	250 000	Capital	125 000
Total	575 000	**Total**	575 000

Additional Information
Gearing Ratio Industry Average 60%
Liquidity Ratio Industry Average 3:1

The assets and liabilities are classified as follows:

Current assets – assets that are cash or are expected to be converted to cash in the current accounting period. They are said to be liquid and include cash, accounts receivable and inventory (stock).

Non-current assets – assets that are not expected to be converted to cash and include the plant and equipment and good will.

Current Liabilities – debts that the business will repay in the current accounting period (credit card and overdraft)

Non-current Liabilities – debts that are not expected to be paid in the current accounting period (mortgage, long term loans)

Use the following information to answer the following questions.

Jack's Computer Services Pty Ltd has provided the following data based on the revenue statement for the year ended 30 June 2002. Total Revenue* $5000 Net Profit Ratio 5% Gross Profit Ratio 60% *Total Revenue is equal to Total Sales.

QUESTION (HSC 2002, Q18)
What is the value of the Cost of Goods Sold for Jack's Computer Services Pty Ltd?

A $250
B $500
C $2000
D $3000

QUESTION (HSC 2002, Q19)
The Gross Profit Ratio has increased from 40% in 2001 to 60% in 2002, while revenue and expenses remained the same.

What was the net profit or loss in 2001?

A $750 net loss
B $500 net loss
C $750 net profit
D $2000 net profit

Use the following information to answer the following questions.

Correct Printing
Summary of balance sheet as at 30 June 2004

	($)		($)
Current Assets		**Current Liabilities**	
Cash at Bank	30 000	Accounts Payable	10 000
Accounts Receivable	15 000		
Non-current Assets		**Shareholders' Funds**	60 000
Furniture and Fixtures	20 000	Owners' Equity	?
Printing Machines	30 000		

QUESTION (HSC 2004, Q12)
Calculate the value of Retained Profits.

A 0
B 15 000
C 25 000
D 50 000

QUESTION (HSC 2004, Q13)
Correct Printing has decided to use an overdraft facility to purchase an additional printing machine. How would this affect the Balance Sheet?

A Increase Owners' Equity and decrease Cash at Bank
B Increase Current Liabilities and increase Non-current Assets
C Decrease Cash at Bank and increase Non-current Assets
D Decrease Retained Profits and increase Non-current Assets

Use the following information to answer the following questions.

The cash flow forecast for Nic's Cafe highlights that there may be a liquidity problem.

	October	**November**	**December**	**January**
	$	$	$	$
Opening balance	6 000	5 000	?	?
Cash inflow	7 000	7 000	7 000	10 000
Cash outflow	8 000	16 000	3 000	2 000

QUESTION (HSC 2005, Q14)
In which two months might Nic's Cafe experience a liquidity problem?

A October and November
B November and December
C November and January
D December and January

QUESTION (HSC 2005, Q15)
Which of the following strategies would be most appropriate to solve this liquidity problem at Nic's Cafe?

A Issue debentures
B Obtain a mortgage
C Seek venture capital
D Apply for an overdraft