Chapter 1
Overview of Financial Management

REVIEW QUESTIONS

1. Define the meaning of financial management.

   Financial management means ensuring that a company uses its resources in the most efficient and effective way to maximize the profit generated by a business, which ultimately increases the value of the business.

2. Why is it important for managers to ask questions such as: How are we doing? How will our business be protected?

   These questions describe five major functions of financial management: (1) the company's financial performance; (2) the company's liquidity, or ability to pay expenses and determine the need to borrow funds; (3) how the company's money should be spent; (4) where funds will come from; and (5) how will the business be protected while maximizing investors' share value.

3. Differentiate between the role of the treasurer and the role of the controller.

   The *controller* manages how funds are spent and invested by establishing accounting and financial reporting policies and procedures, maintaining the accounting, auditing, and management control mechanisms, and analyzing financial results. The *treasurer*, on the other hand, is responsible for raising funds and managing the liability and equity side of the statement of financial position.

4. What are the four financial objectives? What do they mean?

   (1) *Efficiency* refers to the relationship between assets and profit. (2) *Liquidity* is a company's ability to meet its short-term financial obligations, such as paying suppliers, creditors, and employees. (3) *Prosperity* is growth in all segments of a business, including revenue, profit, dividend payments, non-current assets, equity, and working capital. (4) *Stability* refers to the financial structure of a business, that is, that there is an appropriate balance between the funds provided by creditors and those provided by shareholders.

5. Comment on the importance of the "return on revenue" financial objective.

   The return on revenue financial objective is a primary measure of the four financial objectives. Efficiency is directly related because the return on revenue shows the efficiency in the use of the assets; liquidity is improved when return on revenue improves; prosperity is enhanced when return on revenue increases; and stability can only be achieved when the return on revenue is stable or increasing.

6. Who is responsible for the business decisions in a business?

   Students may suggest that all managers who are responsible for resources or budgets make the business decisions in a business.

7. Differentiate between internal financing and external financing.

   Internal financing is obtained from retained earnings, that is, profit for the year plus depreciation/amortization, as well as from reductions in working capital accounts. *External financing* is obtained from long-term lenders and shareholders.

8. What are investing decisions and financing decisions?

   Investing decisions are related to the acquisition of non-current assets. These decisions deal with the accounts appearing on the assets side of the statement of financial position such as non-current assets (e.g., property, plant and equipment) and intangible assets. *Financing decisions* deal with the accounts listed on the liability and equity side of the statement of financial position, that is, funds borrowed from long-term lenders, and shareholders.

9. What are non-current assets?

   Non-current assets are permanent assets such as equipment, machinery, and buildings.

10. What are working capital accounts?

    Working capital accounts are shown on the statement of financial position under the headings current assets and current liabilities. These current assets (e.g., inventories and trade receivables) can be converted into cash within a twelve-month period while current liabilities (e.g., trade and other payables, short-term borrowings) must be paid within a twelve-month period. All these accounts are part of the cash conversion cycle and one of the basic objectives of management is to accelerate this cycle.

11. What do we mean by the "matching principle"?

    In financial management, the matching principle refers to relating the maturity of the sources of funds to the maturity of the uses of those funds. For example, short-term borrowings should be used to finance current assets and long-term borrowings should be used to finance the more permanent assets (non-current assets).

12. What is the "weighted average cost of capital"?

    The weighted average cost of capital is the cost associated with financing non-current assets, and usually refers to the more permanent forms of financing such as mortgages, bonds, and preferred and common shares.

13. What is an operating decision? Give some examples.

    An operating decision is a decision that affects the accounts included on the statement of income, such as revenue, cost of sales, distribution costs, and administrative expenses. Examples would include using more efficient manufacturing methods, hiring additional employees, and changing the level of advertising.

14. How can "productivity indicators" and "rewarding quality work" improve the bottom line?

    Using *productivity indicators* improves the bottom line because the most important activities are measured and used as goals, leading to improved productivity and motivation to achieve the goals in a timely manner. *Rewarding quality* work usually leads to lower costs from savings on inspection, waste, and rework, increased productivity, employee pride, and customer loyalty.

15. Why is it important for operating managers to understand the fundamentals of financial management?

    There are three key individuals responsible for finance in business: the treasurer, the controller and operating managers. Operating managers are responsible for making important decisions related to the acquisition of assets (e.g., inventories, trade receivables and non-current assets) and a better understanding of the function of finance will improve their effectiveness in making more enlightened decisions.

16. What is the meaning of transparency?

    Transparency can be defined as how business processes and related information resources, assets, and outcomes can be made more visible and open to inspection by stakeholders.

17. Differentiate between government legislation and corporate governance.

    *Governmen*t (the ultimate gatekeeper of public confidence in public markets) *legislation* has to do with the enactment and implementation of laws for all public company boards, management and public accounting firms. These laws deals with (1) building a stronger framework for effective governance, (2) establishing high standards and healthy board dynamics, (3) setting-up guidance for effective corporate communications, and (4) pin-pointing how red flags should be highlighted to signal the need for prompt investigation and action. *Corporate governance* gives directives to boards members (bear the ultimate authority and accountability for an organization's affairs) on how they should govern their organization. The key responsibility of effective directors and top-level managers is to develop a model of governance that aligns and instills shared values throughout their organization and to evaluate the model periodically for its effectiveness.

18. Describe the role of the International Financial Reporting Interpretation Committee.

    The IFRIC's responsibilities are to interpret the application of IFRS and provide timely guidance on financial reporting issues, publish draft interpretations for public comment, and report to the Standards Advisory Board and obtain the Board's approval for final interpretation.

19. Will the finance function be more important in the future than it was in the past? Discuss.

    Answers should suggest that the finance function is already more important than in the past and will continue to increase in importance as companies compete globally, technological changes occur more and more quickly, and global competition requires responding to requirements of governments of more and more countries.

LEARNING EXERCISES

Exercise 1

Company's return on assets and cost of financing.

Return on assets is 11.3% ($170,000 ÷ $1,510,000)

Cost of financing is 12. %

Question 1: If managers want to earn a 12% return on assets, how much profit must the company generate?

Profit of $181,200 ($1,510,000 x 12%).

Question 2: If managers want to earn a 15% return on assets, how much profit must the company generate?

Profit of $226,500 ($1,510,000 X 15%).

Exercise 2

The italic fonts represent the missing accounts.

The statement of income

	In $
Revenue	*1,000,000*
Cost of sales	(700,000)
Gross profit	300,000
Distribution costs	(200,000)
Profit before taxes	*100,000*
Income tax expense	*(35,000)*
Profit for the year	65,000

The statement of financial position:

Equity	
Share capital	500,000
Retained earnings	*600,000*
Total equity	1,100,000
Long-term borrowings	800,000
Total current liabilities	600,000
Total liabilities	*1,400,000*
Total equity and liabilities	*2,500,000*
Non-current assets	*2,000,000*
Total current assets	500,000
Total assets	2,500,000

Exercise 3

Question 1: As a percentage of revenue, the following shows how much would be kept in the company for growth purposes in working capital and non-current assets and how much would be used to pay dividends.

	in $	as a percentage of revenue
Revenue	3,000,000	1.000
Profit for the year	280,000	.093

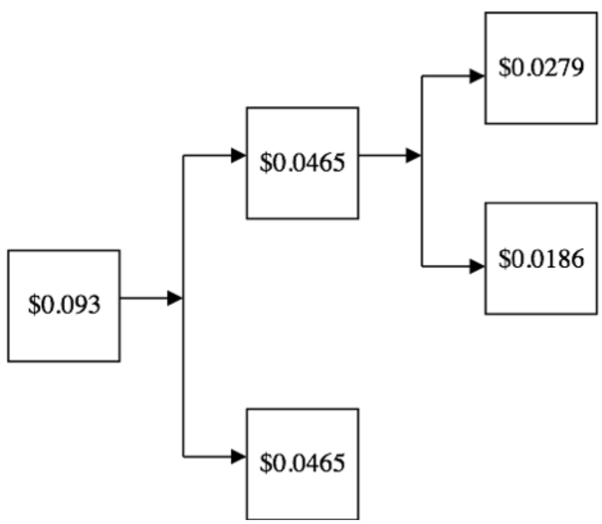
First split:

50% for retained earnings	140,000	or	0.0465
50% for dividends	140,000	or	0.0465
Total	280,000	or	0.0930

Second split:

60% of retained earnings for non-current assets	84,000	or	0.0279
40% of retained earnings for current assets	56,000	or	0.0186
Total	140,000	or	0.0465

The following is a visual presentation of the various splits.



Question 2: Explain who is responsible for making the split between the amount of funds to be retained in the business, and the amount to be paid in dividends.

The members of the board of directors are responsible to make this decision.

Question 3: What do you think the board of directors should do if profit for the year increased to $350,000?

Some of the issues that would be discussed are:

- invest more in the business in the form of working capital
- invest more in the business in the form of non-current assets
- pay more dividends to the shareholders
- reduce the debt
- invest in research and development

Exercise 4

Operating decisions

- Profit for the year
- Depreciation/amortization
- Change in trade receivables
- Net change in short-term borrowings
- Change in trade and other payables

Financing decisions

- Change in long-term borrowings
- Share capital issue

Investing decisions

- Acquisition of a business
- Sale of non-current assets
- Additions to property, plant and equipment

Exercise 5

Question 1: The company's after-tax cost of borrowing is 9.931%.

Source	*Amount* *In $*	*Weight*	*After tax cost %*	*Weighted cost %*
Trade and other payables	200,000	0.087	0.00	0.000
Short-term borrowings	250,000	0.109	5.50	0.599
Mortgage	500,000	0.217	5.25	1.139
Long-term borrowings	250,000	0.109	5.00	0.545
Share capital	300,000	0.130	16.00	2.080
Retained earnings	800,000	0.348	16.00	5.568
	2,300,000	1.000		9.931

Question 2: The company's weighted average cost of capital is 11.612%.

Source	*Amount* *In $*	*Weight*	*After tax cost %*	*Weighted cost %*
Mortgage	500,000	0.270	5.25	1.417
Long-term borrowings	250,000	0.135	5.00	0.675
Share capital	300,000	0.162	16.00	2.592
Retained earnings	800,000	0.433	16.00	6.928
	1,850,000	1.000		11.612

Exercise 6

Question 1: How much cash will be generated from internal operations by the end of 2010?

In $	2009	2010	Cash flow
Trade receivables	250,000	275,000	(25,000)
Inventories	430,000	370,000	60,000
Profit for the year		230,000	230,000
Total cash inflow			265,000

Question 2: Will the owners have to borrow from investors in order to finance the expansion? If yes, how much?

Yes, they will have to borrow from investors $285,000.

Investing activities	$550,000
Operating activities	265,000
Financing activities	$285,000

CASE

Packard Industries Inc.

Question 1: The company's return on total assets in 2009 is 16.3% ($280,000 ÷ $1,720,000).

Question 2: Internally generated cash from operations in 2010, is $419,600.

• Profit for the year	$369,600
• Inventories	20,000
• Trade receivables	30,000
Total cash generated internally	$419,600

From retained earnings

2010 Revenue	$3,080,000 ($2,800,000 x 10% growth)
2010 Profit for the year	$369,600 ($3,080,000 x 12% ROR)

From inventories

Cash provided by inventories:

2009	$300,000
2010	280,000
Difference	$ 20,000

From trade receivables

Cash provided by trade receivables:

2009	$400,000
2010	370,000
Difference	$ 30,000

Question 3: How much cash will management have to borrow if they want to proceed with their $ 800,000 investment in capital assets?

The company would have to borrow $380,400 from external sources (lenders and shareholders)

• Investing activities	$800,000	
• Operating activities	419,600	(internally generated cash)
• Financing activities	$380,400	(external financing)