THE SCHOOL FOR EXCELLENCE

HSC BUSINESS STUDIES
SUMMARY NOTES FOR THE HSC EXAMS

WRITTEN BY A STUDENT WHO OBTAINED A BAND 6 IN THE SUBJECT

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TOPIC 3 – FINANCE

Students learn to:

Examine contemporary business issues to:

Explain potential conflicts between short-term and long-term financial objectives

Analyse the influence of government and the global market on financial management

Identify the limitations of financial reporting

Compare the risks involved in domestic and global financial transactions

Investigate aspects of business using hypothetical situations and actual business case studies to:

Calculate key financial ratios

Assess business performance using comparative ratio analysis

Recommend strategies to improve financial performance

Examine ethical financial reporting practices

Students learn about:

ROLE OF FINANCIAL MANAGEMENT

Strategic role of financial management

Financial Management: planning and monitoring of a business's financial resources to achieve its financial objectives. This is usually in the long term, having broad aims and affecting all key-business areas

- A strategic plan will ensure that the business survives and grows in the competitive market.

- Planning of financial resources are also essential to a business's success and growth

Some strategic roles of financial objects management:

- Setting financial objectives in order to achieve its goals
- Sourcing finance
- Preparing budgets
- Preparing financial statements etc.

Objectives of financial managements

Profitability, growth, efficiency, liquidity, solvency

- **Profitability:** the ability of a business to maximise its profits to ensure long term sustainability
    - A business must carefully monitor revenue and pricing policies, costs and expenses

- **Growth**: The ability for the business to increase in size in the longer term
    - Dependant on the ability to develop and use asset structure to increase sales, profits and market share

- **Efficiency**: the ability of a business to minimise its costs and manage its assets so that maximum profit is achieved with lowest possible level of assets
    - This relates to operations or revenue-producing activities of the business

- **Liquidity**: The extent at which a business can meet its financial commitments in the short term
    - Must have sufficient cash flow to meet financial obligations or be able to convert current assets into cash quickly

- **Solvency**: The extent to which the business can meet its financial commitments in the longer term
    - Particularly important to shareholders, owners and creditors of a business
    - Gearing is an effective measurement for solvency – the proportion of debt and the proportion of equity that is used to finance the activities of a business

Short-term and long-term objectives

- Short-term financial objectives are the tactical (one to two years) and operational (day-to-day) plans of a business.
    - These are reviewed regularly to see if targets are met
- Long-term financial objectives are strategic plans of a business
    - These are determined for a set period of time, generally more than five years.
    - Tend to be brad goals such as increasing profit or market share
    - Reviewed annually to determine if changes need to be implemented

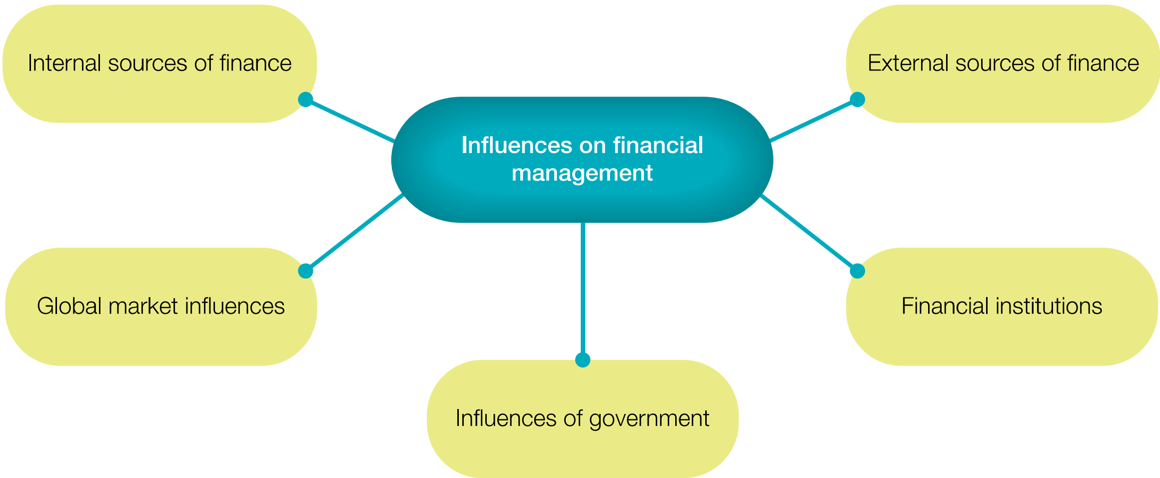
Potential conflicts:

- Potential conflicts between short term and long-term objectives can arise
    - E.g. Common financial long-term objective is growth but expansion is often associated with costs and gearing, which will lead to lower overall profits in the short term
    - Reconciling conflicts by constantly assessing achievement of specific objects to satisfy as many goals as possible

Interdependence with other key business functions

Interdependence refers to the mutual dependence that the key functions have on one another.

- The marketing, operations and human resources departments rely on financial managers to allocate them adequate funds
- Finance department also relies on the other three key business functions in order to generate sales and therefore provide income to the finance department

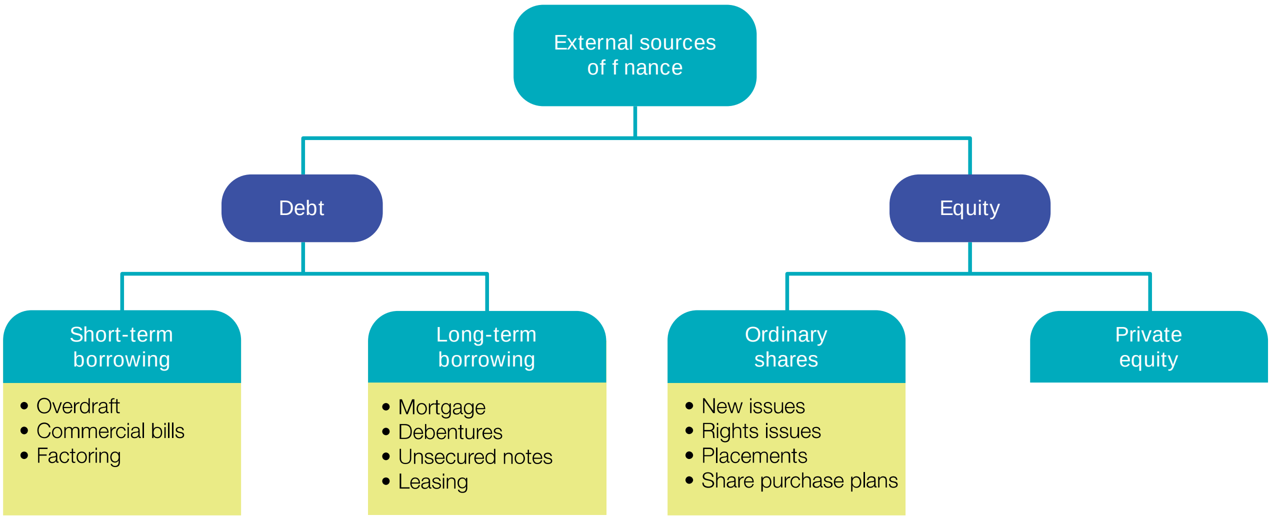


Internal sources of finance – retained profits

Internal finance comes either from business owner's or from the outcomes of business activities

- Owner's equity
    - The funds contributed by owners or partners to establish and build the business
    - Equity capital can be raised by taking on another partner or seeking funds from an investor
    - Sells off any unproductive assets or issues private shares
- Retained profits
    - Retain 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 the future
    - Most businesses keep profits in the form of retained earnings

External sources of finance



External finance refers to funds provided by sources outside of the business.

Finances provided by external sources through creditors or lenders are known as debt finance.

Debt – Short-term borrowing (overdraft, commercial bills, factoring), long term borrowing (mortgage, debentures, unsecured notes, leasing)

Debt: Short term

- Overdraft
  - One of the most common types of short term borrowing
  - A bank allows a business to overdraw its account to an agreed limit
  - Assists businesses with short-term liquidity problems
E.g. Seasonal decrease in sales
  - Costs for overdrafts are minimal and interest rates are lower than other forms of borrowing
  - Require agree limits to the overdraft to be maintained at a high level
  - Repayable on demand
  - Bank loans do not have the same flexibility as overdrafts

- Commercial bills
    - Primarily short-term loans issued by financial institutions, for larger amounts
    - Usually over $100,000 for a period between 30 – 180 days
    - Borrower receives the sum immediately and promises to repay the money within interest at a future time
    - These are flexible both in relation to interest that needs to be paid and the repayment period
    - They are secured against a business's assets and are generally rolled over until the borrower is able to repay in full
- Factoring
    - Short-Term source of borrowing for a business
    - It enables the business to raise funds immediately by selling accounts receivable at a discount to a firm that specialises in collecting accounts receivable
    - The business will receive up to 90% of amounts of receivables in 48 hours
    - By having immediate access, the business can improve its cash flow and gearing
    - Full account will not be received for accounts
    - Factoring companies may offer services:
        - Without recourse: Business transfers responsibility for non-collection to the factoring company
        - With recourse: Bad debts will still be the responsibility of the business
    - This involves greater risks than the other short-term debt finances because of the likelihood of unpaid debts
        - It is an expensive source of finance
        - Factoring was the last resort

Debt: Long term

- Mortgage
    - Loan secured by the property of the borrower (business)
    - The property that is mortgaged cannot be sold or reused as security for further borrowing
    - Used to finance property purchases
    - Repaid with interest through regular repayments over an agreed period of time
- Debentures
    - A promise made by the company to repay the money that has been lent to the business
    - Investor lends money to the company, issues debenture to make regular interest payments
    - Issued by a company for a fixed rate of interest and for a fixed period of time.
    - Raises funds from investors instead of financial institutions.
    - Company repays by buying back the debenture.
    - Products must have a prospectus that informs investors about the business
- Unsecured notes
    - A loan from investors for a set period of time
    - Not secured against the business's assets
    - Presents the most risk to the investors in the note (lender)
    - Attracts a higher rate of interest than a secured note
    - Companies sell unsecured notes to generate money for their initiatives

- Leasing
    - Involves the payment of money for the use of the equipment that is owned by another party
    - Enables enterprise to borrow funds and use equipment without the large capital outlay required.
    - Costs and benefits are transferred from the lessor to the lessee
    - Lessee uses equipment and lessor owns and leases the equipment for an agreed time.
    - Long term leases usually cannot be cancelled.
    - Leasing has been a widely used source of finance in Australia, mainly finance companies E.g. Businesses choose equipment and finance company purchases it on their behalf and leases it to the business.
    - There are two kinds of leases:
        - Operating leases are assets leased for short periods (shorter than life of asset). The owner carries out maintenance on the asset. This can be cancelled
        - Financial leases are usually for the life of the asset. Lease repayments are fixed for economic life of the asset. This includes plant, equipment, vehicles, furniture etc. There are usually penalties for cancellation of financial leases.
    - Advantages include:
        - Costs of establishing leases may be lower than other methods of finance
        - If some assets are leased, business may be in a better position to borrow funds
        - Provides long term financing without reducing control of ownership
        - Permits 100% financial of assets
        - Repayments of the lease are fixed so cash flow can be monitored easily
        - Lease payments are a tax deduction
        - Payments usually include maintenance, insurance and finance costs
    - Disadvantages include:
        - Interest charges may be higher than other forms of borrowing
        - Corporations are required to reveal significant leases in financial statements

Equity – ordinary shares (new issues, rights issues, placements, share purchase plans), private equity

Equity

Refers to finance raised by a company through inviting new owners.

E.g. Done by issuing shares to the public through ASX

- Ordinary shares
    - Most commonly traded shares in Australia
    - Individuals with ordinary shares become part-owners of a publicly listed company.
        - This entails voting rights
        - Receives dividends
    - New issue: A security that has been issued for the first time on a public market
        - Often referred to as an Initial Public Offering (IPO)
        - Business's required to issue a prospectus
    - Rights issue: Privilege granted to shareholders to buy new shares on the same company
        - Occurs after an IPO
        - Provides existing shareholders to purchase more shares
        - Shareholders do not have to take up rights issue
    - Placements: Allotment of shares made directly from the company to investors
        - Additional shares are offered at a discount to their current trading price
        - Intended to persuade specific investors to invest in the company
    - Share purchase plan: An offer to existing shareholders in a listed company to purchase more shares in the company without brokerage fees.
        - Can also be offered at a discount
        - Allows companies to issue new shares without a prospectus
        - Can only use a maximum of $150, 000 in new shares to each shareholder
- Private equity

Refers to the money invested in a private company not listed on the ASX. The aim of a private company is to raise capital to finance future expansion/investment of the business.

Financial institutions

Banks, investment banks, finance companies, superannuation funds, life insurance companies, unit trusts and the ASX

Banks:

- Major operators in financial market
- Most important source of funds for businesses
- Receives savings as deposits from individuals, businesses and government – in turn making investments and loans to borrowers
- Most funds come from banks who operate on their own behalf or on behalf of others
- Largest form of financial institution in Australia
- Share has declines as the financial market became deregulated

Investment banks:

- Provides services in both borrowing and lending, primarily to the business sector
- E.g. Maquarie bank
- Provides a wide variety of loans for different business's needs.
- Investment banks:
  - Trade in money, securities and financial futures
  - Arrange long term finance for company expansion
  - Provide working capital
  - Arrange project finance
  - Advise clients on foreign exchange cover
  - Advise on mergers and takeovers
  - Provide portfolio investment management services
  - Underwrite corporate and semi-government issues of securities
  - Operate unit trusts including cash management trusts, property trusts and equity trusts
  - Arrange overseas finance

Finance companies:

- Non-bank financial intermediaries that specialise in smaller commercial finance.
- Provides mainly short term and medium-term loans to businesses through consumer hire-purchase loans, personal loans and secured loans
- Major providers of lease finance to businesses
- Some specialise in factoring or cash flow financing
- Raises money through share issues (debentures)
- Lenders have security of priority over the firm's assets in event of liquidation
    - Finance company is able to sell the assets of the business to recover the initial loan if the business fails
- Can provide businesses with quick access to funds, but interest rates are usually higher
- Regulated by the **Australian Prudential Regulation Authority**

Superannuation funds:

- Grown rapidly due to tax incentives and compulsory super payments introduced by governments
- Employers are required to make super contributions for all employees aged between 18 and 69 who are paid more than $450 before tax in a calendar month
- Provides funds to the corporate sector through investment of funds received from superannuation contributions
- Able to invest in long-term securities as company shares, government and company debt because of its long term nature

Life insurance companies:

- Non- bank financial intermediaries who provide cover and a lump sum payment in the event of death
- Policy holders pay regular **premiums** and insurer guarantees to pay the designated beneficiary a sum of money upon death of insured person
- Provides both equity and loans to the corporate sector through receipts of insurance premiums
    - Provides funds for investment
    - Received in premiums called reserves and are invested in financial assets

Unit trusts:

- **(AKA Mutual funds)**
- Take funds from a large number of small investors and invest them in specific types of financial assets
- Include the short-term money market, shares, mortgages and property, and public securities
- Usually connected to a management firm that manages a diversified investment portfolio for its investors

ASX:

- Created by merging the ASX and the Sydney futures exchange in July 2006.
- Primary stock exchange group in Australia
- Where shares are primarily bought and sold
- Functions as a market operator, clearing house and payments system facilitator
- Oversees compliance with its operating rules and promotes standards of corporate governance
- Offers services including:
    - Shares
    - Futures
    - Exchange traded options
    - Warrants
    - Contracts for difference
    - Exchange traded funds
    - Real estate investment trusts
    - Listed investment companies
    - Interest rate securities
- Biggest stocks traded include BHP Billiton, CBA, Rio Tinto etc.
- Acts as a primary market to raise new capital through issuing shares
- Also acts as a secondary market where preowned or second-hand securities are traded between investors who are individuals, businesses, government or financial institutions.
    - Transactions in this market do not increase total amount of financial assets
    - Secondary market increases liquidity of financial assets and influences primary market for securities

Influence of government

Influences a business's decision making through economic policies, legislation and various roles of government bodies or departments who are responsible for monitoring and administration

ASIC, company taxation

ASIC:

- The Australian Securities and Investments Commission
- An independent statutory commission accountable to the Commonwealth parliament
- Enforces and administers the *Corporations Act 2001*
- Protects consumers in the areas of investments, life and general insurance, superannuation and banking (except lending)
- Assists in reducing fraud and unfair practices in financial markets and financial products
- Ensures that companies adhere to law, collects information about companies and publicises
    - Includes financial information that companies disclose in annual reports
- If a business breaches the law, ASIC will investigate the matter and determine a remedy
- Failure to comply generates negative publicity for the business

Company taxation:

- All businesses that have been incorporated (Public and private companies) are required to pay company tax on profits
- Tax is levied at a flat rate of 30% of net profit
    - Unlike personal income taxes that use progressive scale
- Company tax is paid before profits are distributed to shareholders as dividends
- Aus. Government has reformed federal tax system that will improve Australia's international competitiveness and allow it to be more attractive to invest in
- Will result in more jobs and higher wages for working Australians
- Plans to further reduce the company tax rate by 1.5% from 1 July 2015

Global market influences

Economic outlook, availability of funds, interest rates

Global economic outlook:

Refers specifically to the projected changes to the level of economic growth throughout the world

- If outlook is positive, this will impact financial decisions by:
    - Increasing demand for products and services
        - Businesses will need to increase production to meet demand
        - Requires purchasing equipment, employ or train staff
    - Decrease the interest rates on funds borrowed internationally from the financial money market.
        - This may result in decrease of risk.
        - As business sales increase, profits increase
    - Poor economic outlook will impact on financial decisions of a business in the opposite way

Availability of funds:

Refers to the ease with which a business can access funds on the international financial markets

Various conditions and rates apply and these will be based primarily on:

- Risk
- Demand and supply
- Domestic economic conditions

Interest rates:

The cost of borrowing money.

- The higher the risk involved in lending to a business, the higher the interest rates
- Australian interest rates tend to be above those of other countries such as USA
- Australian businesses would be tempted to borrow the finance from an overseas source to gain the advantage of lower interest rates.
- Real risk is exchange rate movements

Influence of government on global market on financial management:

Implications for businesses in relation to the influence of government

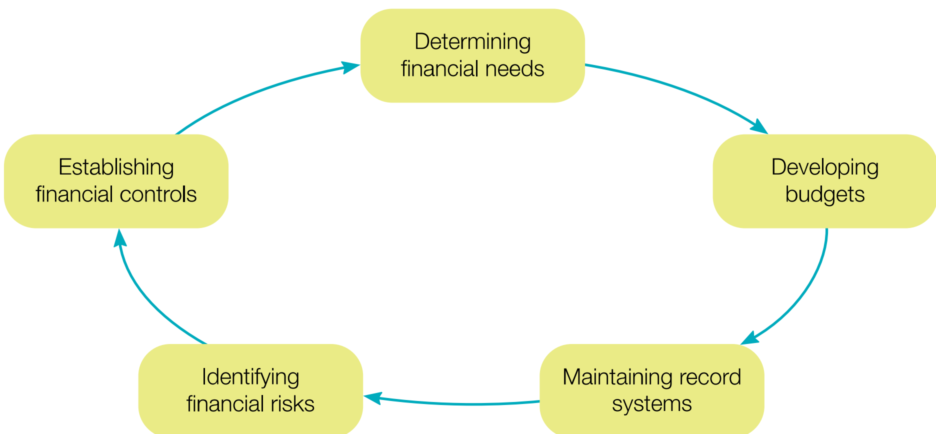
- Legislation will influence the decision businesses make about their finances
- Businesses need to ensure they comply with legal obligations
- Legislation impacts on choice of legal structure as different obligations are imposed on different types of businesses
- Don’t comply with regulations, ASIC can pursue a range of remedies
- Negative publicity
- Taxation regulations will affect business’s financial decisions as some decisions might be better for taxation purposes
- Taxation regulations require sound financial management to have enough resources available for when taxation obligations are due

Implications from global market:

- Global economic outlook will have a direct effect on the demand for Australian exports
    - Positive outlook will increase demand for Australian products
    - Negative outlook will decrease demand
- Availability of funds will impact on whether Australian businesses can access the money they need to expand
- Overseas interest rates will affect Australian businesses who borrow funds from overseas
    - If interest rates and or exchange rate changes, this could lead to an increase in repayments and a reduction in profits

Processes of financial management

Planning and implementing



Financial needs, budgets, record systems, financial risks, financial controls

Financial needs:

It is important to determine what a business's financial needs are to determine progress and future potential. This can be determined by:

- The size of the business
- The current phase of the business cycle
- Future plans for growth and development
- Capacity to source finance – debt and equity
- Management skills for assessing financial needs and planning

Institutions need to guarantee that their financial commitments to the business will be successful. This may also include analysis of financial performance, income statement, cash flow statement, balance sheet and financial ratio analysis reports.

Budgets:

Important planning tool to assist a business to estimate resource requirements for a specified future period to predict what will be achieved by a business.

Provide information in quantitative terms about requirements to achieve a particular purpose. They can show:

- Cash required for planned outlays for a particular period
- The 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

Budgets provide financial information for a business's goals and are used in strategic, tactical and operational planning

Enables constant monitoring of objectives and provides a basis for:

- Administrative control
- Direction of sales effort
- Production planning
- Control of stocks
- Price setting
- Financial requirements
- Control of expenses
- Production cost

Various factors need to be considered in preparing one:

- Review of past figures and trends, estimates gathered from relevant departments in the business
- Potential market or market share, trends and seasonal fluctuations in the market
- Proposed expansion or discontinuation of projects
- Proposals to alter price or quality of products
- Current orders and plant capacity
- Considerations from the external environment
    - E.g. Financial trends from external environment, availability of materials and labour

Budgets are often prepared to predict a range of activities relating to short term and longer-term plans and activities. They can be categorised into three types:

- **Operating budgets:** Budgets for the main activities of a business
    - May include budgets relating to sales, production, raw materials, direct labour, expenses and costs of goods sold.
    - Information from this is used to prepare budgeted financial statements
- **Project budgets**: Budgets for capital expenditure, research and development
    - Includes information about the purpose of the asset purchase, life span of the asset and the revenue that would be generated from the purchase
    - This is also included in budgeted financial statements
- **Financial budgets:** The financial data of a business
    - Predictions of the operating and project budgets are included in the budgeted financial sheet and cash flows.
    - Income statement and balance sheet reflect operating activities and the cash flow statement shows the liquidity of a business

Record systems:

The mechanisms employed by a business to ensure that data are recorded and the information provided by record systems are accurate, reliable, efficient and accessible

1. Needs to minimise errors in recording process
2. Producing accurate and reliable financial statements are important aspects of maintaining record systems
3. Double entry system of accounting is important control aspect

Financial risks:

The risk of a business being unable to cover its financial obligations, such as debts from borrowings. If this occurs, bankruptcy will result.

- If a business is financed from borrowings, there is a higher risk. The higher the risk, the greater the expectation of profits or dividends.
- To minimise financial risk, businesses consider how much profit will be generated
- Profit must be enough to cover cost of debt and increasing profits to justify amount of risk taken by owners and shareholders.
- Liquidity of a business's assets must also be considered.
- Short term debt = must have liquid assets so debts, including interest payments and payments for principal on loans can be covered.

Financial controls:

Financial problems and losses prevent a business from achieving its coals. Most common causes of problems are:

1. Theft

   Include unnecessary or over-purchase of stock for personal use, conflict of interest, misuse of expense accounts, false invoices, theft of inventory or assets and credit card fraud.

2. Fraud
3. Damage or loss of assets
4. Errors in record systems

Financial control ensures that the plans that have been determined will lead to the achievement of the business's goals in the most efficient way.

- This is particularly important in assets such as accounts receivable, inventory and cash

Common policies include:

- Clear authorisation and responsibility for tasks in the business
- Separation of duties
- Rotation of duties
- Control of cash
- Protection of assets – locking buildings etc.
- Control of credit procedures – e.g. following overdue accounts

Debt and equity financing – advantages and disadvantages of each

External or **debt** finance is a liability to a business as it is money owed to external sources

Advantages of debt	Disadvantages of debt
• Funds are usually readily available and can be acquired at short notice.	• There is an increased risk if debt comes from financial institutions because interest, bank charges and government charges may increase.
• Increased funds should lead to increased earnings and profits.	• Security is required by the business.
• Interest payments are tax deductible.	• Regular repayments have to be made.
• Flexible payment periods and types of debt are available.	• Lenders have first claim on any money if the business ends in bankruptcy.
• It will not dilute the current ownership in the business.	• Debt can be expensive, e.g. interest must be paid.

Equity finance relates to the internal sources of finance in the business

Advantages	Disadvantages
Does not have to be repaid unless the owner leaves the business	Lower profits and lower returns for the owner
Cheaper than other sources of finance as there are no interest payments	The expectation that the owner will have about the return on investment (ROI)
The owners who have contributed the equity retain control over how that finance is used	Long, expensive process to obtain funds this way
Low gearing (use resources of the owner and not external sources of finance)	Ownership is diluted, i.e. the current owners will have less control
Less risk for the business and the owner	

- In terms of equity, shareholder funds represent highest proportion of total funds to finance business operations and assets.
- The most important source of funds for companies because it stays in the business for an indefinite time, as funds do not have to be repaid at a set date
- Equity is generally safer than debt but requires sufficient profits to be made so they can operate

When deciding what type of finance to use, businesses will compare debt with equity and take into account what the finance is needed for – the purpose. They must match terms and sources of finance to purpose.

Debt	Equity
• Lenders have prior claim in the event of liquidation	• Shareholders have a residual claim on assets
• Debt must be repaid by periodic repayments	• Equity has no maturity date
• Interest payments are tax deductible	• Dividends are not tax deductible
• Lenders usually require a lower rate of return	• Shareholders require higher return due to higher risk
• Interest payments are fixed	• Dividend payments are not fixed and may be reduced through lack of funds
• Debt providers have no voting rights	• Equity holders have voting rights

Matching the terms and source of finance to business purpose

- The terms of finance must be suitable for the purpose for which the funds are required
- E.g. Use of short term to fund long-term assets causes financial problems because mount borrowed must be repaid before the long-term assets have time to generate increased cash flow.
- Use of long term finance for short term situations means business is still paying the mortgage after situation is resolved
- Finance managers should match length or term of the loan with economic lifetime of the asset
- Short term finance should be used to purchase short term assets
- E.g. inventory (current or short-term asset) should be purchased with trade credit whereas new building, (noncurrent asset), should be purchased with a mortgage

Monitoring and controlling

Process of monitoring and controlling is important especially in the process of financial management. Inconsistent methods of review will have impact on the viability of the business

The main controls used are:

Cash flow statement, income statement, balance sheet

Cash flow statement:

- Provides the link between the income statement and balance sheet
- Gives important information regarding a firm's ability to pay its debts on time
- Indicates the movement of cash receipts and cash payments resulting from transactions over a period of time.
- Can also identify trends and be a useful predictor of change
- Users include creditors and lenders of finance as well as owners and shareholders, assessing a business's ability to manage its cash.
- Potential shareholders check that a business has had positive cash flows over a number of years
- Fluctuating pattern of cash flows might point to difficulties.

Cash flow statement can show whether a firm can:

- Generate a favourable cash flow (inflows exceeding outflows)
- Pay its financial commitments as they fall due
  E.g. interest on borrowings
- Have sufficient funds for future expansion or change
- Obtain finance from external sources when needed
- Pay drawings to owners or dividends to shareholders

In a cash flow statement, activities are commonly divided into three categories:

- Operating activities:
  - The cash inflows and outflows relating to purchase and sale of non-current assets and investments
  - These assets and investments are used to generate income for the business
  - E.g. Selling of an old motor vehicle, purchasing new plant and equipment or purchasing property
- Investing activities:
  - Cash inflows and outflows relating to purchase and sale of non-current assets and investments. Assets and investments are used to generate income for the business
  - E.g. selling of an old motor vehicle, purchasing new plant and equipment or purchasing property

- Financing activities:
  - Cash inflows and outflows relating to the borrowing activities of the business
  - Borrowing inflows can relate to equity (issue shares or capital contribution from owner) or debt (loans from financial institutions).
  - Cash flows relate to the repayments of debt and cash drawings of the owner payments of dividends to shareholders

This is usually prepared from the income statement and balance sheet, as it summarises the transactions of the business.

Burgess Enterprises Ltd
Cash flow statement for year ended 30 June 2014

Cash flows from operating activities	
Receipts from customers	30 000
Payments to suppliers and employees	(25 000)
Dividends received	4 000
Interest received	8 000
Interest paid	(5 500)
Net cash provided by operating activities	11 500
Cash flows from investing activities	
Proceeds from sale of assets	85 000
Payment of plant and equipment	(150 000)
Net cash from investing activities	(65 000)
Cash flows from financing activities	
Proceeds from issues of shares	90 000
Proceeds from borrowings	40 000
Repayments of borrowings	(15 000)
Dividends paid	(25 000)
Net cash from financing activities	90 000
Net increase in cash	36 500
Cash at the beginning of the reporting period	15 000
Cash at the end of the reporting period	51 500

Add all the cash receipts from operating activities and subtract the cash payments.

Add all the cash receipts from investing activities and subtract the cash payments.

Add all the cash receipts from financing activities and subtract the cash payments.

Add net cash provided from operating activities + net cash provided from investing activities + net cash provided from financing activities.

Cash at beginning of year + net increase in cash (this amount will then become the new 'cash at the beginning of the year' for the next period).

Income statement:

A summary of the income earned and the expenses incurred over a period of trading

- Helps business see how much revenue, expenditure and profit from a set period

Income statement shows:

- Operating income earned from the main function of the business
  - Sales of inventories
  - Services and non-operating revenue from other operations
  - Interest
  - Rent
  - Commission

- Operating expenses such as the purchase of inventories, payment for services and other expenses incurred in the main operation of the business

  - Advertising
  - Rent
  - Telephone
  - Insurance

Completing a statement of financial performance:

1. Record income earned by a business
2. Record **cost of goods sold**
3. Calculate **Gross profit**
4. Record all expenses
5. Calculate **net profit**

Common expenses include:

- Wages and salaries
- Payments for telephone
- Electricity
- Postage
- Motor vehicle expenses

Expenses*		
Selling	**Administrative**	**Financial**
• Commission • Salaries • Wages • Advertising • Delivery expenses • Electricity • Depreciation on shop fittings	• Stationery • Office salaries • Rent • Rates • Telephone • Depreciation on buildings • Audit fees • Accountant's fees • Insurances	• Interest payments • Lease payments • Dividends • Insurance payments
Selling expenses:	These relate to the process of selling the good or service and can be directly traced to the need for sales.	
Administration expenses:	Costs directly related to the general running of the business.	
Finance expenses:	Costs associated with borrowing money from outside people or organisations and to minimising business risk.	

Can also be referred to as Sales or Revenue. This represents the total value of all the goods/services sold.

Gross Profit = Operating Income/Sales – COGS

COGS = Opening Stock + Purchases – Closing Stock

Income Statement
for the year ended 30 June 2014

	2012 $	2013 $	2014 $
Operating income	81 200	83 500	78 800
Cost of goods sold			
Opening inventory	11 280	11 300	11 240
Purchases	53 000	55 200	48 000
	64 280	66 500	59 240
Closing inventory	11 300	11 240	11 100
	52 980	55 260	48 140
Gross profit	28 220	28 240	30 660
Expenses			
Selling	7 800	9 200	8 900
Administrative	4 400	4 400	7 000
Interest	3 000	3 500	3 000
	15 200	17 100	18 900
Operating profit before tax	13 020	11 140	11 760
Tax	4 500	3 900	4 100
Operating profit after tax	8 520	7 240	7 660
Extraordinary items (after tax)	4 300	4 600	3 900
Operating profit and extraordinary items after tax	12 820	11 840	11 560
Retained profits (1 July)	25 000	31 000	35 000
	37 820	42 840	46 560
Dividends paid	3 400	2 900	3 800
Retained profits (30 June)	34 420	39 940	42 760

Retained/Net Profit = Gross Profit – Expenses

Balance sheets:

Represents a business's assets and liabilities at a particular point in time and represents the net worth (equity) of a business.

- Shows the financial stability of the business
- Prepared at the end of the accounting period

Balance sheet shows the level of current and non-current assets, current and non-current liabilities – including investments and owner's equity.

Assets:

- Items of value owned by the business
- Current assets can be turned into cash within 12 months
- Non-current assets are not expected to be turned into cash within 12 months

Liabilities:

- Claims by people other than owners against assets
- Represents what is **owed** by the business

Owner's Equity:

- The funds contributed by the owner(s) and represents the net worth of the business

Example of balance sheet:

Balance Sheet
as at 30 June 2014

Assets	**$m**	**Liabilities**	**$m**
Current Assets		**Current Liabilities**	
Cash	86.3	Accounts payable	438.3
Accounts receivables	578.5	Overdraft	253.3
Inventories	100.8	**Total Current Liabilities**	691.6
Total Current Assets	765.6	**Non-current Liabilities**	
Non-current Assets		Borrowings	1347.4
Investments	589.3	**Total Non-current Liabilities**	1347.4
Property, plant and equipment	2182.2		
Intangibles	189.8	**Total Liabilities**	2039.0
Total Non-current Assets	2961.3	**Net Assets**	1687.9
		Shareholders' Equity	
		Share capital	988.4
		Reserves	75.2
		Retained profits	624.3
Total Assets	3726.9	**Total Shareholders' Equity**	1687.9

A balance sheet can indicate whether:

- A business has enough assets to cover its debts
- The interest and money borrowed can be paid
- The assets of the business are being used to maximise profits
- The owners of the business are making a good return on their investments

Shows:

- Return on owner's investment
- Sources and extent of borrowing
- Level of inventories
- Whether business has sufficient assets to continue to make profits in the long-term
- How much assets are financed from outside borrowings
- Whether business can meet financial obligations
- How the year's figure compares to previous years

Comparative balance sheet:

Balance Sheet
as at 30 June 2014

	Consolidated	
	2013 $m	2014 $m
Current Assets		
Cash	4.8	20.6
Accounts receivable	102.0	81.6
Investments	14.9	—
Inventories	36.0	31.5
Total Current Assets	157.7	133.7
Non-current Assets		
Receivables	59.3	64.7
Investments	284.7	293.5
Inventories	17.3	79.5
Property, plant and equipment	831.4	882.9
Intangibles	5.1	5.6
Total Non-current Assets	1197.8	1326.2
Total Assets	1355.5	1459.9
Current Liabilities		
Creditors and borrowings	190.0	118.2
Provisions	59.6	51.7
Total Current Liabilities	249.6	169.9
Non-current Liabilities		
Creditors and borrowings	238.7	417.6
Provisions	210.2	208.4
Total Non-current Liabilities	448.9	626.0
Total Liabilities	698.5	795.9
Net Assets	657.0	664.0
Proprietors' Equity		
Share capital	132.3	182.7
Reserves	228.3	235.1
Retained profits	161.9	111.7
Equity attributable to proprietors of the chief entity	522.5	529.5
Reserve account	134.5	134.5
Total capital and reserves	657.0	664.0

Accounting equations:

Assets = Liabilities + Owners' equity
Owners' equity = Assets − Liabilities
Liabilities = Assets − Owners' equity

Financial ratios

Main types of financial analysis:

- Vertical analysis
  - Compares figures within one financial year
  - E.g. Expressing gross profit as a percentage of sales and comparing debt to equity
- Horizontal analysis:
  - Compares figures from different financial years
  - E.g. Comparing 2014 and 2015
- Trend Analysis:
  - Compares figures for periods of three to five years

Liquidity – Current ratio (current assets / current liabilities)

Liquidity is the extent to which the business can meet its financial commitments in the short term.

Expressed as a ratio: E.g. 2: 1 (2:1 is safe - too high shows an inefficient use of assets)

Associated management strategies:

- Reduce current liabilities
- Sell non-essential non-current assets or lease/factor them
- Inject more equity into the business to pay off liabilities

Ratio example:

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$
$$= \frac{300\,000}{195\,000}$$
$$= 1.54$$

Comment: This firm has $1.54 of current assets to cover $1 of current liabilities. A ratio of less than 1:1 indicates there are insufficient assets to pay current commitments or liabilities. If this firm has previously operated successfully, it may find a ratio of 1.54:1 acceptable. However, if this is not the case, the firm may have to sell non-current assets to cover liabilities, which will reduce its capacity to earn profits; or it may have to borrow in the short term and incur higher interest repayments. In most instances, a firm would be unwise to allow this ratio to fall below 1.5:1.

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$
$$= \frac{450\,000}{150\,000}$$
$$= 3:1$$

Comment: This firm has $3 of current assets for every $1 of current liabilities. This indicates that the firm is in a sound financial position — that is, it is liquid and will be able to pay for its debts in the short term. If the firm has a high demand for its product, for example, food products, there may be reason to reduce the level of its current ratio. Even for a firm that has a low demand, for example, jewellery, its working capital may be too high. Too high a ratio can mean that current assets are not being used fully. Action is needed to ensure that sufficient use is being made of the assets in the business.

SOLVENCY -- Gearing – debt to equity ratio (total liabilities / total equity)

- *The ability for a business to meet its financial commitments in the longer term*
- *Gearing measures the relationships between debt and equity*

Expressed as ratio/number:

- An important control aspect for management as this ratio must be carefully balanced.
- Ratio of greater than 1 means business has less equity then debt
- Ratio of between 0 and 1 means that business has more equity than debt
- The higher the ratio, the less solvent the firm
  - The higher the ratio, the higher the risk

Strategies:

- Look at ways to reduce debt or increase equity
- To decrease debt, businesses could sell non-essential assets to pay off their debts
- Could renegotiate their loans to spread payment over a longer period
- Business could lease assets as opposed to purchasing them
- To increase equity, a business could retain more profits or inject more equity funding by either selling ore shares or inviting new owners.

Profitability –

Gross profit ratio (gross profit / sales),

- *Used by trading businesses (that purchase foods from suppliers and sells them at a higher price to customers)*
- *Shows percentage of sales revenue that results from gross profit*
- *Indicates the effectiveness of planning policies concerning pricing, sales, discounts, the valuation of stock etc.*

Expressed as a ratio:

- If ratio is low, alternative suppliers may need to be sources and competitors investigated

Associated management strategies:

- Seek better deals for stock purchases
- Concentrate on stock with higher turnovers

Net Profit Ratio (Net Profit / Sales) x 100

- *Shows the amount of sales revenue that results in net profit*
- *Costs or expenses after gross profit must be ow enough to generate a net profit*
- *Amount of sales must be sufficiently high to cover the costs or expenses of the firm and still result in a profit.*
- *Businesses should be aiming for a high gross and net profit ratio*

Expressed as a percentage: (A lower figure needs attention)

Associated management strategies:

- Monitor and control expenses
- Increase volume of sales to compensate for smaller profit margins

Income Statement for Young's Corner Store, 2014

		$	$
Revenue		100 000	
less Cost of goods sold		80 000	
Gross profit			20 000
less Selling expenses		3 000	
less Administrative expenses		1 500	
less Financial expenses		500	5 000
Net profit			15 000
Opening stock	$15 000		
Closing stock	$25 000		
Accounts receivable	$10 000		

This means that for every dollar of sales revenue the business earned, it retained 20 cents as gross profit. Another way of looking at this ratio is that cost of goods sold consumed 80 cents of every dollar of sales revenue.

(a) Gross profit ratio $= \dfrac{\text{Gross profit}}{\text{Sales}}$

$= \dfrac{20\,000}{100\,000} \times 100$

$= 20\%$

(b) Net profit ratio $= \dfrac{\text{Net profit}}{\text{Sales}}$

$= \dfrac{15\,000}{100\,000} \times 100$

$= 15\%$

This means that for every dollar of sales revenue the business earned, it retained 15 cents as net profit.

Return on Owner's Equity (Net Profit / Owner's Equity) x 100

- *Shows how effective the funds contributed by the owners have been in generating profit*

- *Return for owners should be better than return gained from alternative investments*

Expressed as a percentage: (A lower figure needs attention)

- The higher the ratio or percentage, the better the return for the owner
- If returns are favourable, owners can consider expansion or diversification
- If return is unfavourable, owners could consider selling off business.

Associated management strategies:

- Reduce unnecessary assets
- Re-examine areas of operation to concentrate on more profitable areas

Example Return on Equity ratio:

$$\text{Return on equity} = \frac{\text{Net profit}}{\text{Total equity}}$$

$$= \frac{15\,000}{150\,000} = 0.1\% \text{ or } 10\%$$

Comment: This means that for every $1 of equity contributed by the owners, they receive 10 cents in return. In this example, a return of 10 per cent would be seen as a reasonable investment. Depending on other information, the owner would need to consider alternatives for investment, such as bank interest rates.

Efficiency – Expense ratio (total expenses / sales) x 100

- The ability of the firm to use its resources effectively in ensuring financial stability and profitability of the business.

- Relates to the effectiveness of management in managing goals and objectives

- The more efficient, the greater the profits and financial stability

Expressed as a percentage: (A high or rising figure isn't good and needs attention)

- Compares total expenses with sales
- Indicates the amount of sales that are allocated to individual expenses
  - E.g. selling, administration, COGs and financial expenses
- Indicates the day-to-day efficiency of the business
- A business aims to keep expenses at a reasonable level
  - If selling ratio has increased, it could be due to advertising costs and how this has not generated the expected sales.
  - A decline in expense ratio may be a result of lower interest rates or less debt being used by the firm
- As business varies, the standard percentage varies. Results should be compared with previous results
  - Rising percentage needs attention
- If expense ratio is too high, business should look at ways to monitor and control expenses

Accounts receivable turnover ratio (sales / accounts receivable

- Measures the effectiveness of a firm's credit policy and how efficiently it collects its debts.
- Measures how many times the Accounts Receivable balance is converted into cash or how quickly debtors pay their accounts.
- Dividing ration in 365 can determine the average length of time it takes to convert balance into cash

Expressed in days: (A figure no bigger than 10 days is desirable)

- Discount early payments and cash payments
- Charge interest on late payments
- Use outside credit facilities in order to avoid credit exposure e.g. Visa

Example Accounts turnover ratio:

Income Statement for Young's Corner Store, 2014	$	$
Revenue	100 000	
less Cost of goods sold	80 000	
Gross profit		20 000
less Selling expenses	3 000	
less Administrative expenses	1 500	
less Financial expenses	500	5 000
Net profit		15 000
Opening stock $15 000		
Closing stock $25 000		
Accounts receivable $10 000		

(a) Expense ratio (selling expenses) $= \frac{\text{Selling expenses}}{\text{Sales}} = \frac{3000 \times 100}{100\,000} = 3\%$

(b) Expense ratio (administrative expenses) $= \frac{\text{Administrative expenses}}{\text{Sales}} = \frac{1500 \times 100}{100\,000} = 1.5\%$

(c) Expense ratio (financial expenses) $= \frac{\text{Financial expenses}}{\text{Sales}} = \frac{500 \times 100}{100\,000} = 0.5\%$

(d) Accounts receivable turnover ratio $= \frac{\text{Sales}}{\text{Accounts receivable}} = \frac{100\,000}{10\,000} = 10$

$\frac{365}{10} = 36.5$ days

Comment: Depending on the type of business and past trends, the firm has made a reasonable gross and net profit and their expense ratios are quite low. For every $1 returned as sales, 3 cents is absorbed by selling expenses, 1.5 cents by administrative expenses and 0.5 cents by financial expenses. While this is quite low, these figures would need to be compared to previous years' results.

Debt collection figures indicate relative efficiency in the collection of debts. Debts are being repaid on an average of 36.5 days (assuming that the firm has a billing cycle of 30 days). There is no meaningful average for this ratio, mainly because credit terms differ among businesses. Businesses should therefore compare this result to their credit policy to see if customers are taking too long to pay. As a general rule, however, a high accounts receivable turnover ratio can be improved by demanding payment of overdue accounts.

Ratio	Formula	Example on page	Analysis of which aspect of the financial statement	What does analysis of this ratio show about a business?	Interpretations of ratio results
Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$	300	Liquidity	Shows the short-term financial stability of a business (i.e. its ability to meet its short-term financial commitments)	It is generally accepted that a ratio of 2:1 indicates a sound financial position (i.e. a firm should have double the amount of assets to cover its liabilities).
Debt to equity ratio	$\frac{\text{Total liabilities}}{\text{Total equity}}$	303	Gearing (Solvency)	Shows the extent to which the firm is relying on debt or outside sources to finance the business	The higher the ratio, the less solvent the firm (i.e. the higher the ratio of debt to equity, the higher the business risk).
Gross profit ratio	$\frac{\text{Gross profit}}{\text{Sales}}$	305	Profitability	Shows the percentage of sales revenue that results in gross profit.	The higher the ratio the better. If the ratio is low, alternative suppliers may need to be sourced and competitors investigated.
Net profit ratio	$\frac{\text{Net profit}}{\text{Sales}}$ *(Net profit is gross profit less expenses)*	305	Profitability	Net profit ratio represents the profit or return to the owners.	A firm will be aiming for a high net profit ratio. A low net profit ratio indicates strategies to reduce expenses and increase revenue need to be investigated.
Return on equity ratio	$\frac{\text{Net profit}}{\text{Total equity}}$	306	Profitability	Shows how effective the funds contributed by the owners have been in generating profit and so the return on investment (ROI)	The higher the ratio or percentage, the better the return for the owner, although comparisons need to be made with alternative investments.
Expense ratio	$\frac{\text{Total expenses}}{\text{Sales}}$	307	Efficiency	Each of the categories of expenses is compared with sales. The ratio indicates the amount of sales that are allocated to individual expenses such as selling, administration, COGS and financial expenses.	Expense ratios indicate day-to-day efficiency of the business. Expense ratios need to be kept at a reasonable level, and management must monitor each type of expense in relation to sales. Higher expense ratios may be the result of poor management.
Accounts receivable turnover ratio	$\frac{\text{Sales}}{\text{Accounts receivable}}$	307	Efficiency	Measures the effectiveness of a firm's credit policy and how efficiently it collects its debt.	High turnover ratios indicate the business has efficient debt collection.

Comparative ratio analysis – over different time periods, against standards, with similar business

- Figures, percentages and ratios do not provide a complete picture for analysis
- Comparisons and benchmarks are needed
- Judgements are made by comparing a firm's analysis against other figures, percentages and ratios.

Comparisons can be made in a multitude of ways:

- With results from previous years
- With similar businesses
- Against common industry standards or benchmarks
    - Must be comparing the same things
    - Each firm has it's differences

Analysis can also include budget figures so predicted figures can be compared against actual figures over short periods. This is available for parties within a firm rather than shareholders.

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

Normalised Earnings:

- Earnings that have been adjusted to take into account changes into the economic cycle or remove one off outliers that will affect profitability
- Done to give more accurate information on a company's true earnings
- Easier to compare profitability figures for a business
- E.g. A removal of a land sale, which would achieve large capital gain
- E.g. A one-off MAJOR event occurring that affects a business's sales

Capitalising expenses:

- Accounting method where a business records an expense as an asset on the balance sheet rather than as an expense
- Does not accurately represent the true financial condition of the business as it understates the expenses and overstates the profits as well as the assets
- E.g. Research and development, development and expenditure

Valuing Assets:

- Process of estimating value of assets when recording them on a balance sheet
- Difficult to estimate especially non-current assets
- Value is often written as a historical cost, an accounting method where assets are listed on a balance sheet at the value they were purchased
    - Advantage is that it can be verified
    - Disadvantage is that value may distort business's balance sheet, as it will not accurately represent the true worth of the business's assets because the original cost may be different
- Non-current assets usually increase over time (land) or may decrease in value (Motor vehicles) – this is known as depreciation.
- Business estimate how much value is lost overtime
- Therefore, it is a limitation as depreciation rate is an estimate and may give false impression on how much the business is actually worth.
- Some assets are difficult to value – intangible assets such as good will, trademarks, patents and brand names.
    - There may be a temptation to over value them

Timing issues:

- Under the matching principle, expenses incurred by a business must be recorded on the income statement for the accounting period in which the revenue is earnt.
- Expenses don't match up to revenue
- E.g. Real estate may have sold a property in June but employer does not pay them until July.
- Revenue earned will match costs that were incurred to earn that revenue
- This presents a more accurate representation of the financial position

Debt Repayments:

- Gearing ratio is often used to determine a business's risk of meeting long-term financial commitments
    - Highly geared: Alarming to stake holders
    - But increased risk as potential for profit is greater
    - E.g. Higher debt to fund growth can mean more profits in the future
- Financial reports can therefore be limited

- They do not have the capacity to disclose:
  - How long a business has been recovering the debt
  - Capacity of the business or the debtor to repay the amounts owed
  - Adequacy of provisions and methods the business has for the recovery of debt (Larger businesses have the ability to outsource debt recovery by hiring agent, but smaller businesses cannot)
  - Provisions businesses have in place for doubtful debts and how this is evident in financial reports
  - Whether they are being held over until another accounting period, giving a false impression of the situation
  - When debts are due
- Can be used to distort the reality of the business's status and be undertaken to gain a more favourable view of the business

Notes to the financial statements:

- Reports the details and additional information that are left out of the main reporting documents
- These contain information that could be useful to stakeholders
- Contains accounting methodologies and further details about how figures were calculated

Ethical issues related to financial reports

- Any attempt to engage in creative accounting to portray a more favourable and inaccurate picture should be avoided
- The valuing of assets should be particularly done ethically
- If debt funds are used extensively to finance activities in a business, there is an added risk for shareholders
  - Impact of these risks is an ethical issue to be considered
- Expenditures and revenues are estimated
  - These should not be overestimated and revenues should not be understated
  - Done to allow for unexpected and uncertain events

Laws that relate to this; Directors have a duty to:

- Act in good faith
- Exercise power for proper purpose
- Exercise discretion reasonably and properly
- Avoid conflicts of interest

Audited Accounts:

- An independent check of the accuracy of financial records and accounting procedures.
- Potential users of information (e.g. shareholders) rely on auditors before they make important decisions about the business.

There are three types of Audits:

1. Internal Audits:
    - Conducted internally by employees to check accounting procedures and the accuracy of financial records
2. Management Audits:
    - Conducted to review the firm's strategic plan and to determine if changes should be made
    - Factors affecting strategic plan include human resources, production processes and finance
3. External Audits:
    - Requirements of the Corporations Act (2001)
    - Firms financial reports are investigated by independent and specialised audit accountants to guarantee their authenticity
    - Auditor issues a statement that indicates that the business complies with Australian auditing standards

- Internal and external audits assist in preventing unnecessary waste and inefficient use of resources, misuse of funds, fraud and theft.
- E.g. Cash is counted, condition and amount of inventory is checked and accounts receivable and non-current assets are checked
- External auditors are used to provide an annual audit of accounting practice and procedures
- Small businesses commonly require audits if the business is for sale or to check against fraud or theft
- Auditors employ highly trained public accountants

Record keeping:

- *Accounting processes depend on how accurately and honestly data is recorded in financial reports*
- *Source documents must be created for every transaction*
- *Temptation to receive transactions "cash in hand" and not record the transaction*
  - *This could reduce the revenue, reducing the profit and reducing the tax burden*
  - *The ATO regulates this and tax evasion can receive fines, harming the reputation of the business etc.*

Reporting practices:

- Other stakeholders are entitled to access the business's financial information
- Shareholders in a private company are legally entitled to receive financial reports annually
- Pretending that profit is lower is an attempt to defraud the ATO
  - This is illegal and unethical and can have other negative consequences
- A business may wish to raise additional capital from existing shareholders or from a bank, understating profit may make it more difficult to persuade those sources of finance to lend to the business.
- Any purchaser of a business on sale would want to see financial reports for a number of years prior to sale. Understating or overstating value of assets are counter-productive.

FINANCIAL MANAGEMENTS STRATEGIES

Cash flow management

Cash flow statements

- Cash flow is the movement of cash in and out of a business over a period of time.
- Matching cash flow in with cash flow out is essential.
- By making a cash flow statement, the business knows how much they have at a given time and can further analyse trends to improve efficiency as cash flows can be a better predictor of a business's status rather than profitability.
- The term 'liquidity' is used to describe whether a business has an adequate cash flow.

Cash Inflow examples:

Sales, Cash payments for accounts receivables, sales of assets, proceeds from issue of shares. Cash outflow examples: Payment to suppliers, drawings, loan repayments.

The cash flow statement provides the link between the income statement and balance sheet, as it gives important information regarding a firm's ability to pay its debts on time. A fluctuating pattern of cash flows might point to difficulties in the business. Remember that only cash transactions are included in the cash flow statement.

Limitations:

The record does not tell what debts the business has or what is owed to the business itself by others.

Distribution of payments, discounts for early payment, factoring

Distribution of payments:

- This involves distributing payments throughout a time period so that large expenses do not occur at the same time and cash shortfalls do not occur.
- Distributing payments throughout the year means there is a more equal cash outflow each month rather than large fluctuations in particular months.

Discounts for early payments:

- A business' goal is to ensure that many creditors do not use the **distribution of payments** strategy, as it could negatively affect the cash flow status.
- This can be overcome by offering creditors a discount for early payments.
- This strategy is most effective when targeted at those creditors who owe the largest amounts over the financial year period.

Factoring:

- This enables a business to raise funds immediately by selling accounts receivable at a discount to a firm that specialises in collecting accounts receivable (a finance or factoring business).

- The business saves on the costs involved in following up on unpaid accounts and debt collection.

- By having immediate access to funds, the business will improve its cash flow and gearing. However, it must be remembered that the full amount will not be received for accounts.

Working capital management

Working capital is the term used in businesses to describe the funds available for the short-term financial commitments of a business. Net working capital = current assets - current liabilities.

Control of current assets – cash, receivables, inventories

- Control of current assets requires management to select the optimal amount of each current asset held, as well as raising the finance required to fund those assets.

- The costs and benefits of holding too much or too little of each asset must be assessed.

- Working capital must be sufficient to maintain liquidity and access to credit (overdraft) to meet unexpected and unforeseen circumstances.

Cash:

- Cash ensures that the business can pay its debts, repay loans and pay accounts in the short term, and that the business survives in the long term.

- Supplies of cash also enable management to take advantage of investment opportunities.

- Businesses try to keep their cash balances at a minimum and hold marketable securities as reserves of liquidity.

- Reserves of cash and marketable securities guard against sudden shortages or disruptions to cash flow.

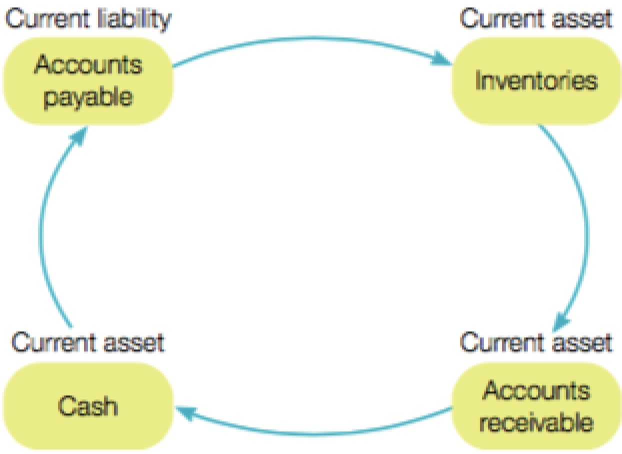
Accounts Receivable:

- The collection of receivables is important in the management of working capital.
- Consequently, a business must monitor its accounts receivable and ensure that their timing allows the business to maintain adequate cash resources.
- **Strategies for managing accounts receivable include:**
    - Sending monthly statements to customers, stipulating a reasonable period for accounts (ideally 30 days).

Inventories:

- Inventories make up a significant amount of current assets, and their levels must be carefully monitored so that excess or insufficient levels of stock do not occur.
- Inventory is a cost to the business if it remains unsold:
    - the holding of too much stock means unnecessary expenses.
    - 'Just-in-time' is one method used by some businesses to ensure that inventory is not lying idle.

Working Cycle:



Control of current liabilities – payables, loans, overdraft

- Current liabilities are financial commitments that must be paid by a business in the short term by converting current assets into cash to ensure that the business' creditors are paid.

- Minimising the costs related to a firm's current liabilities is an important part of the management of working capital.

Accounts payables:

- The holding back of accounts payable until their final due date can improve a firm's liquidity position OR it may also be possible to take advantage of discounts offered by some creditors, which reduces costs and assists with cash flow.

- Accounts must, however, be paid by their due dates to avoid any extra charges imposed for late payment and to ensure that trade credit will be extended to the business in the future.

- As there are costs involved in providing and receiving credit, businesses may negotiate reduced prices if credit card facilities are used.

- Costs and benefits in using credit must be determined in the control of accounts payable.

Loans:

- Management of loans is important, as costs for establishment, interest rates and ongoing charges must be investigated and monitored to minimise costs.

- Short-term loans are generally an expensive form of borrowing for a business and their use should be minimised.

- Bridging finance can be provided by banks to cover times when funds from the settlement of asset sales, such as property, have not been received but payment for another property is required.

- However, the costs in interest rates and charges associated with bridging nance are high.

Overdraft:

- Features of overdrafts differ between banks, but generally involve an arrangement with the bank that the business's account can be overdrawn to a certain amount.

- They enable a business to overcome temporary cash shortages.

- Banks require that regular payments be made on overdrafts and may charge extra fees, but interest is usually less than that for a loan.

- Bank charges still need to be carefully monitored and businesses should have a policy for using and managing overdrafts and monitor budgets on a daily or weekly basis so that cash supplies can be controlled.

Strategies – leasing, sale and lease back

Leasing:

- Leasing is the hiring of an asset from another person or company who has purchased the asset and retains ownership of it.
- Firms can also increase their number of assets through leasing and this means that revenue, and therefore profits, can be increased.
- Regular and fixed payments made for the lease can be planned to match the business's cash flow.
- **Note** that as it is an expense, it is also tax deductible.

Sale and leaseback:

- The selling of an owned asset to a lessor and leasing the asset back through fixed payments for a specified number of years.
- Sale and lease- back increases a business's liquidity because the cash that is obtained from the sale is then used as working capital.

Profitability management

Cost controls – fixed and variable, cost centres, expense minimisation

The costs associated with a decision need to be carefully examined before it is implemented.

Fixed and Variable:

- Fixed costs are not dependent on the level of operating activity in a business - they must be paid regardless of what happens in the business.
- Variable costs are those that change proportionately with the level of operating activity in a business.
- Changes in the volume of activity need to be managed in terms of the associated changes in costs.
- Comparisons of costs with budgets, standards and previous periods ensure that costs are minimised and profits maximised.

Cost Centres:

- These are particular areas, departments or sections of a business to which costs can be directly attributed.
- They have both direct costs and indirect costs. Direct costs are those that can be allocated to a particular product. Direct costs are also called variable costs.
    - E.g. depreciation of equipment that was used solely in the production of one good.
- Indirect costs are those that are shared by more than one product.
    - E.g. depreciation of equipment used to make several products would have indirect costs allocated on some equitable basis.

Expense minimisation:

- Profits can be weakened if the expenses of a business are high, as they consume valuable resources within a business.
- Guidelines and policies should be established to encourage staff to minimise expenses where possible.

Revenue controls – marketing objectives

Marketing strategies and objectives should lead to an increase in sales and hence an increase in revenue.

- Sales objectives must be pitched at a level of sales that will cover costs, both fixed and variable, and result in a profit.
- Businesses should focus on the customer base on which most of the revenue depends before diversifying or extending product ranges or ceasing production on particular lines.
- Pricing policy affects revenue and, therefore, affects working capital.
- Pricing decisions should be closely monitored and controlled.

Global financial management

Financial risks associated with global expansion are greater than those encountered domestically, but such risk taking is necessary for the business strategy to be implemented.

Exchange rates

The **foreign exchange rate** is the ratio of one currency to another; it tells how much a unit of one currency is worth in terms of another.

- Exchange rates fluctuate over time due to variations in demand and supply.
- Such fluctuations in the exchange rate create further risk for global business.
- When revenues and expenses are transferred between nations, the exchange rate can either increase or decrease their value.
- Currency fluctuations will also affect the business's ability to meet their financial objectives.

A currency appreciation raises the value of the Australian dollar in terms of foreign currencies.

- This means that each unit of foreign currency buys fewer Australian dollars.
- However, one Australian dollar buys more foreign currency.
- Therefore, an appreciation makes our exports more expensive on international markets but prices for imports will fall.
- The result of the appreciation, therefore, reduces the international competitiveness of Australian exporting businesses.

A currency depreciation has the opposite impact.

- A depreciation lowers the price of Australian dollars in terms of foreign currencies.
- Therefore, each unit of foreign currency buys more Australian dollars. The result is that our exports become cheaper and the price of imports will rise.
- A depreciation, therefore, improves the international competitiveness of Australian exporting businesses.

Interest rates

- A global business has the option of borrowing money from financial institutions within Australia, or borrow money from financial markets overseas, which tend to be cheaper than Australian interest rates.
- However, the real risk here is exchange rate movements as any adverse currency fluctuation could make the advantage of borrowing money at a cheaper interest rate overseas turn into to a disadvantage as the interest rate will naturally increase.
- Changes in interest rates will therefore have a major impact on a business's profitability if they have borrowed money from finance markets overseas.

Methods of international payment – payment in advance, letter of credit, clean payment, bill of exchange

Payment in advance:

- Allows the exporter to receive payment and then arrange for the goods to be sent.

Letter of credit:

- A document that a buyer can request from their bank that guarantees the payment of goods will be transferred to the seller.

- The letter of credit is issued by the importer's bank to the exporter promising to pay them a specified amount once certain conditions have been met.

Clean payment

- Occurs when the exporter ships the goods directly to the importer before payment is received.

Bill of exchange:

- A document drawn up by the exporter demanding payment from the importer at a specified time. This method of payment is one of the most widely used and allows the exporter to maintain control over the goods until payment is either made or guaranteed. There are two types:

Bill against payment:

- Using this method, the importer can collect the goods only after paying for them.

- The exporter draws up a bill of exchange with his or her Australian bank and sends it to the importer's bank along with a set of documents that will allow the importer to collect the goods.

- The importer's bank hands over the documents only after payment is made.

- The importer's bank then transfers the funds to the exporter's bank.

Bill against acceptance:

- Using this method, the importer may collect the goods before paying for them.

- The same process applies as with documents against payment, except the importer must sign only acceptance of the goods and the terms of the bill of exchange to receive the documents that allow him or her to pay for the goods at a later date.

Hedging

- When two parties agree to exchange currency, and finalise a deal immediately, this is referred to as a 'spot exchange'
- The exchange rate to determine these transactions are known as **spot exchange rates,** the value of one currency to another currency on a particular day.
- Due to fluctuations of the Exchange Rate, it is necessary to engage **hedging** to minimise the risk of currency fluctuations
- Hedging helps reduce the level of uncertainty involved with international financial transactions

Natural hedging:

A business can have multiple ways to minimise or eliminate the risk of foreign exchange exposure:

- Establishing offshore subsidiaries
- Stores overseas in the country they are trading in
- Arranging for import payments and export receipts denominated in the same foreign currency. Any losses from a movement in the ER will be offset by gains from the other
- Marketing strategies to attempt to reduce the price sensitivity of the exported products
- Insisting on both import and export contracts in AUD to transfer risks to the buyer

Financial Instrument hedging:

There are a number of financial products available, called derivatives, to minimise or spread the risk of exchange rate fluctuations

Derivatives

Forward exchange contract:

A contract to exchange one currency for another currency at an agreed exchange rate on a future date

- Usually after a period of 30, 90 or 180 days
- The bank guarantees the exporter, within the set time, a fixed rate of exchange for the money generated from the sale of the exported goods.
- E.g. The Apples in America may become more expensive as Australian dollar drops – so the bank guarantees a set price / exchange rate for this deal in the future for a period of time

Options contract:

- Foreign currency options provide another strategy risk for risk management
- An **option** gives the buyer the right, but not the obligation, to buy or sell foreign currency at some time in the future
- Option holders are protected from unfavourable exchange rate fluctuations
- They maintain the opportunity to gain money if the ER movements are favourable

Swap contract:

- Introduced in 1980s
- Very popular financial instrument for businesses to hedge
- A **Currency swap** is an agreement to exchange currency in the spot market with an agreement to reverse the transaction in the future
- Involves spot sale of one currency together with a forward repurchase of the currency at a specific date in the future
- E.g. Swapping $50 million AUD for USD now and an agreement to reverse the swap in three months
- Businesses use this when they need to raise finance in a currency issued by a country which they are not well known and are forced to pay a higher interest
- E.g. A medium-sized Australian business needs Japanese yen, but is not well known in Japan. It can find a Japanese business (or a Broker can find one) that wants AUD and the swap can proceed.
    - The Australian business borrows AUD in Australia where it is well known and can arrange a loan for a cheaper interest rate to the Japanese business in exchange for yen.
    - The Japanese business would repay the Australian dollar loan and vice versa