- **Strategic Role of Financial Management**

The strategic role of financial management is to maximise business profitability.

The finance KBF assists the other KBFs to accomplish their goals and objectives by providing the necessary funds (interdependence)

Finance provides the necessary monitoring function in order to inform executive management on whether the other KBFs are meeting their goals or not.

There are five key financial objectives for financial management:

1. **P**rofitability - the ability of a business to make a financial return from business activities
2. **L**iquidity - the ability of a business to meet short term obligations (measures repayments of short term debt)
3. **E**fficiency - the ability of a business to manage speed and cost of production in order to generate income
4. **G**rowth - the increase in size and value of a business in the long term. Helps maximise shareholder returns
5. **S**olvency - the ability of a business to meet long term debt obligations (gearing)

**PLEGS**

Performance objectives = profitability, efficiency, growth (assessed comparatively against competitor)
Financial position objectives = liquidity, solvency

Conflicts between objectives:

- Growth and Profit - long term growth minimises short term profit
- Growth and Efficiency - long term growth initially decreases production speed and increases costs
- Growth and Liquidity - a business must use capital to grow whilst maintaining a positive cash flow

- **Interdependence with other KBFs**

- Finance depends on marketing to generate funds. Marketing needs finance to fund marketing plan and strategies.
- Finance depends on HR to provide appropriate staff for function. HR depends on finance to provide funds for remuneration of staff and HR strategies.
- Finance depends on operations producing the good/service in order to be sold and generate the necessary funds. Operations needs finance to fund the required inputs as well as provide adequate budgets and cost controls.

- **Influences on Financial Management**

"Sources of finance" are the ways a business funds its assets, potential expansion plans and provide working capital for the business.

- ***Internal sources***

    - Retained profits - the profit left over after being distributed

*Other internal sources - selling assets & shareholder capital
*Internal sources are preferable to external sources in order to refrain from going into debt (mainly retained profits)

- ***External sources***

    - **Equity**
        - Ordinary shares (new issue, rights issue, placement, share purchase plan)
            - **N**ew Issue - source new shareholders from primary market
            - **R**ights Issue - selling new shares to current shareholders only
            - **P**lacement - set or bundle of shares (100s or 1000s) to existing or new shareholders
            - **S**hare Purchase Plan - to existing shareholders, discounted bundles
        - Private Equity - the business is raising finance by having another business purchase shares (private equity firm)
            - When a company is first formed, private equity is used to raise initial equity finance to begin operations and R&D
                - Venture Capital (establishment stage)
            - Private equity is also raised when a business wants to expand but does not want to take on debt or raise capital through public or existing shareholders (growth or maturity stage)
            - Eg. Private equity firm invests in a startup private company. Immediately they own 25% of shares. Private equity then helps build the business and pushes it toward floating. Once the business becomes public, the private equity firm cashes out by selling the shares to the secondary market for a profit.

- **Debt** - a promise to pay, usually with interest, to a debt holder in the future (short or long term)
  - Short term debt - funds that come from outside the business and must be repaid within 12 months

| | |
|---|---|
| **Bank Overdraft** | - A permanent facility attached to a bank account whereby a business can overdraw the account.<br>- Any deposit into that account will reduce the overdraft.<br>- Used when working capital is low<br>- Attracts high interest rates, therefore not used for long term asset funding |
| **Commercial Bills** | - Short term loans issued by financial institutions for relatively large amounts<br>- Non-bank financial institutions and banks act as intermediaries whereby a business/person with excess cash can give a bank money with a fee and the bank will loan it out to a business in need with interest<br>- Interest rates can be fixed or variable and have a period of 30, 60, 90 or 180 days<br>- A short term debenture |
| **Factoring** **(invoice financing)** | - A business sells its accounts receivable to a finance company at a discount, usually 5-10%<br>- The finance company collects the full amounts and retains the entire amount<br>- The business receives instant cash for its accounts receivable in one bulk payment<br>- Helps to improve cash flow |

  - Long term debt - funds that come from outside the business and must be repaid at a date further than 1 year away

| | |
|---|---|
| **Mortgage** | - A secured loan on real estate<br>- Lowest interest rates of all loans with the property as collateral<br>- Fixed term usually between 10-30 years<br>- Quick to secure but include stamp duty and establishment fees |
| **Debenture** | - Long term loans from the public, organised by financial institutions. Used to raise large amounts of money. Secured based on finance company's assets<br>- Long term version of commercial bill<br>- AKA bonds |
| **Unsecured Notes** | - Debenture without security (collateral) |
| **Leasing** | - An agreement whereby the owner of an asset lends that asset to a business for a fee<br>- Leasing is an expense on the income statement, not found on the balance sheet |

- ***Financial Institutions***

Financial institutions provide necessary capital (both debt and equity) for large businesses in the economy, so these institutions have a lot of influence over financial management.

The major participants include:

- Banks
    - Takes deposits and uses funds to make loans
        - Personal loans, mortgages, overdrafts, business loans
    - Also provides financial advice and services such as BPAY and EFTPOS

- Finance and Insurance Companies
    - Specialise in collecting investor capital and issuing smaller commercial loans
    - Regulated by Australian Financial Institutions Commission (AFIC)
    - Loans, leases, factoring and equity capital to higher risk businesses
    - Finance companies issue notes and debentures whereas insurance companies receive money (premiums) from people who buy insurance.

- Investment Banks
    - Dealing with medium to large businesses and corporations
    - Provide commercial bills and organise company floats
    - Raises capital through underwriting share issues

- Superannuation Funds
    - Use individuals savings and invest it in property and equities
    - Provide equity capital in long-term loans to large, safe businesses
    - Generates large investor capital injections into businesses

- Unit Trusts
    - Another term for mutual fund
    - Could provide dividend capital and growth of portfolio

- ASX
    - Functions as the market operator
    - Has the power to delist/suspend a company that isn't following rules
        - Primary market issues raise capital
        - Secondary market buys and sells second hand shares of a business

- ***Influence of Government***

There are also several government bodies that regulate the flow of funds and companies as a whole. They impact how financial management must operate and what funds are available and accessible. These include:

- ASIC (Australian Securities Investment Commission), which regulates how companies behave in the Australian economy and they do this through enforcing the Corporations Act 2001 (Cwlth).

- ATO (Australian Taxation Office), overlooks and collects company tax requirements enforced by the Australian government. Company tax influences net profits and as such impacts financial decisions.

- APRA (Australian Prudential Regulation Authority), which regulates financial institutions and how they borrow and lend capital.

- RBA (Reserve Bank of Australia) is the central bank which ensures financial stability for Australia's economy. They do this by influencing the level of interest rates and money flowing through the economy.

- ***Global Market Influences***

- Economic outlook (international)
  - Boom and recessionary periods which might impact economies and businesses
  - The economic cycle is important to understand consumer demand
    - Eg. a positive economic outlook would lead to higher consumption, meaning a greater demand for a business' product. This would lead the business to seek more capital in order to increase supply.

- Availability of funds (international)
  - This is impacted by the economic outlook and revolves around the ease of which a business can access funds in the global market
  - The global market is prepared to lend money to individuals, companies and governments who need to raise capital
    - Eg. Telstra were able to raise 600 million euro in unsecured notes at a rate of 1.135% to assist with working capital issues.
  - If a business can access low interest debt markets, this is highly desirable for debt financing.

- Interest rates (international)
    - Interest rates are the cost of borrowing money
    - Higher level of risk to lender = higher interest rate charged
    - Traditionally, Aus interest rates have been higher than overseas so Aus businesses usually try to raise capital overseas
    - The concern with raising capital overseas is the exchange rate risk for the business.

    - **Processes of Financial Management**

- ***Planning and Implementing***

Management needs to have a business plan in place in order to let the finance team know what money is needed and when. This requires accurate estimates and forecasts. The business must plan a clear system where outflows of money (costs) are matched with inflows of money (sales) to avoid problems in the short and long term. Managers will then identify the financial actions that need to be taken to achieve the business goals.

Good financial management is absolutely crucial to the smooth running of a business. Many issues arise when a business does not properly manage its finances.

*The Planning Cycle*

**Financial Needs**
Understanding the current financial position is essential to achieve business goals and objectives. This requires accurate estimates and forecasting and will identify:

- The amount of finance needed
- The source of finance available
- The effectiveness of current financial strategies in achieving the vision, goals and objectives of the business plan

Business must conduct a situational analysis (SWOT) of the current financial position from previous income and cash flow statements and balance sheets. This provides more info on current financial issues and trends

**Budgets**
A budget is the most common tool for planning expected costs and revenues over a set period of time. This allows the business to make a rational financial decision based on data and keep their spending to a planned level
It is often adjusted because of the dynamic business environment
The types of budgets are:

- Operating budgets - day to day costs and revenues
- Project budgets - growth of the business
- Financial budgets - overall health of the business

**Record Systems**

Without budgets or any other system of recording information, the business would be unable to accurately control its spending and still be able to ensure liquidity and solvency.
Cash flow statements, income statements and balance sheets are examples of much needed records and are used to store data such as:

- Sales and expenses
- Assets and liabilities
- Customer supplies
- Product information

Management Information Systems (MIS) software coordinate the large volume of data generated by businesses to manage financial data.
An effective record system must be reliable, accurate and comprehensive and make it possible for a business to:

- Improve efficiency
- Identify concerns and opportunities
- Continually monitor performance
- Respond quicker to change
- Produce financial reports to shareholders
- Comply with tax requirements

**Financial Risk**
Financial risk involves identifying and analysing factors that could harm the financial position of the business. These could be either internal or external.
The business must minimise risk so they can take advantage of opportunities.
The main types of financial risk are:

- The business will not have enough cash flow to meet its short-term financial commitments - liquidity risk
- Debt financing if payments are not made - solvency or liquidity risk
- Uncertainty - something could cause harm to the business but may not

Businesses take these risks in order to achieve financial objectives (PLEGS).
Examples include heavy reliance on a piece of machinery (machine breaks, business loses), rising interest rates, low liquidity rates (could not handle a sudden need for cash).

**Financial Controls**
Provide feedback on financial performance. This may require day-to-day adjustments (through financial management strategies) to improve the financial performance of the business in areas such as liquidity or solvency.
Financial controls include:

- Budgets
- Cash flow statements, income statements and balance sheets
- Financial management strategies
- Ratios and comparative analysis - used to asses actual performance of business against industry benchmarks and planned performance

- *Debt and Equity Financing*

Debt refers to borrowed funds, while equity is giving some ownership of the firm to the public.

Debt can be attractive as it is readily available and interest payments are tax deductible which lowers the overall cost of the debt. However, debt can impact the future financial stability of the business, as interest payments are an expense which is recorded on the income statement; so you must ensure that repayments can be afforded and made.

Sometimes equity is a better way to go as raising money through investors does not provide the same level of risk as there are no requirements to repay the funds. The new owners do however expect a share of any profits made, so while the business might continue to grow, the income for the original owners may decline.

***Advantages***

| **Debt Financing** | **Equity Financing** |
|---|---|
| ● Ownership/control retained by business<br>● Interest repayments tax deductible<br>● Loan funds often easier and quicker to obtain than equity finance<br>● Loans provide opportunity to grow<br>● Profits not shared with loan provider | ● Capital does not have to be repaid with interest, within a set time<br>● Owners receive returns through dividends & repayments and increase share value<br>● Greater potential for growth as owners vested interest in success of business<br>● Debt to equity (gearing/liquidity) ratio decreases, lowering risk to business |

***Disadvantages***

| | **Debt Financing** | **Equity Financing** |
|---|---|---|
| ***Costs*** | ● Initial establishment costs, ongoing fees and charges<br>● Interest has to be paid on funds borrowed<br>● Interest rates can vary over life of loan, making loan more expensive than originally planned<br>● Repayment often fixed and inflexible<br>● Amount must be repaid in set period of time | ● Increase number of owners, reducing level of control and increasing sharing of profits and time taken to make decisions<br>● Longer term - more expensive than debt - dividends paid to shareholders and owners expect higher returns on capital invested<br>● Equity often hard to obtain and can take time to organise thereby limiting growth<br>● Legal and administration costs<br>● Equity funding not tax deductible |
| ***Risks*** | - Interest rates may increase, thus increasing the cost of loan and interest payments<br>- Cash flow difficulties may develop, causing difficulty repaying loan and may | - Central control of ownership reduced, causing loss of control in decision making<br>- High demand for dividend payments to shareholders may reduce level of retained profits |

| | | |
|---|---|---|
| | lead to default<br>- If a secured loan, defaulting may lead to loss of assets<br>- Debt to equity ratio may increase, affecting solvency and long term stability | - Business more open to takeovers if another business buys majority shareholding |

- *Matching terms and sources of finance for business purposes*

Businesses must find the source of finance that will be the most appropriate to fund the activities arising from these decisions. This is influenced by:

- Terms of finance - must be suitable for the structure of the business and the purpose for which the funds are required. For example:
  - Short-term finance should match short-term purposes such as managing a temporary cash flow shortage
  - Long-term finance should be assessed for long-term purposes such as an expansion of the business overseas
- Cost of source of finance - whether from equity (share issues and retained profits) or debt should be determined before commitment.
  - The required rate of return that can be expected is also taken into consideration and balanced against the costs of each source.
- Structure of the business
  - Small businesses have fewer opportunities to raise equity capital than larger businesses
  - Equity from unincorporated businesses have to be raised from private sources or by taking on another partner
  - Corporate businesses can raise equity by issuing shares to the public
  - It is common for businesses to use reserves or retained profits when they wish to expand their operations
- Flexibility
- Cost of finance
- Level of control
- Availability of finance

- **Monitoring and Controlling + Financial Ratios + Financial Management Strategies**

- ***Balance Sheet (monitoring and controlling + ratios)***

Balance sheets must balance with accounting equation (A = L + OE)
The balance sheet can be used to analyse these business areas:
- Liquidity (CA / CL) Current
- Gearing (TL / OE) Debt to Equity (Solvency)
- Profitability (Net Profit / OE) ROE
- Efficiency (Sales / AR → 365 / Answer) AR turnover

Once we monitor and assess the current financial position, financial managers have the opportunity to control the issues that arise through strategies.

- **Working Capital Management Strategies (strategies)**

***Strategies to improve liquidity:***
- Control of current assets
- Control of current liabilities

***Control of Current Assets:***
1) **CASH** - most businesses have an **overdraft** facility from a bank. This short term loan allows immediate access to funds when cash is low. Should only be used in the short term.
2) **ACCOUNTS RECEIVABLES (customers owe the business money)**:
    a) **Batching invoices** - issue invoices to customers more regularly - every 7 days rather than monthly.
    b) **Tighten Credit policy** - changing the terms of credit - eg. from 30 days to 7 days.
    **c)** **Credit Control Officer** and **Credit Check -** Having an employee whose sole job is to chase after unpaid invoices and ensure customers are credit worthy before a sale is made.
3) **INVENTORY CONTROLS**
    **a)** **Just In Time Production** and other operations strategies which aid in the efficient use of inventory. Lowering the amount of inventory to what is needed per day/week/month. Frees up cash flow.

***Control of Current Liabilities:***
1) **ACCOUNTS PAYABLE**:
    a) We try to lengthen the terms of trade from suppliers. Eg. 7 days to 1 month. May need to buy in bulk.
    b) If the business has not done so, request trade credit from suppliers
2) **LOANS AND OVERDRAFT: [can be used for solvency issues as well]**
    a) Refinance loans for longer duration or lower interest rates or both

b) Fully used overdraft facility may need to be converted into a long term loan with lower interest rates.

***Solvency Strategies [can be used for liquidity as well]:***

- **Leasing -** instead of buying an asset, lease it instead. This is an expense on the income statement rather than an asset which needs debt or equity capital.
- **Sale and lease back -** sell an asset, use the money from the asset's sale to pay back debt, then lease the asset back. Removes the asset and debt from the balance sheet but adds an expense to the income statement.

- ***Income Statement (monitoring and controlling + ratios)***

The income statement shows financial performance in these areas:

- Profitability
- Efficiency

Profitability ratios:

1. Net Profit ratio → Net Profit / Sales
2. Gross Profit ratio → Gross Profit / Sales
   a. Using these two ratios helps to pinpoint a COGS or expenses issue in profitability
3. Return on Equity (ROE) → Net Profit / Owners Equity
   a. Aiming for over 10%

Efficiency ratios:

1. Expense ratio → Expenses / Sales
   a. Should be kept low
2. Accounts Receivables Turnover ratio → Sales / Accounts Receivables
   a. Shows liquidity and efficiency
   b. Must convert to days!

- ***Profitability Management Strategies (strategies)***

These strategies are usually related to the income statement and the financial ratios of profitability and efficiency. There are two types of strategies:

- Cost Controls → connected to operations
- Revenue Controls → connected to marketing

***Cost Controls - fixed and variable costs, cost centres, expense minimisation***

- Fixed costs of the business include the non-current assets of the business such as equipment, buildings, vehicles, etc. They can also include full-time wages.

- Variable costs are those costs that change with the level of business activity. High revenue = high variable costs.
    - How can we control variable costs?
        - Outsourcing - reduce wages, usage of electricity, rent, floor space
        - JIT - can reduce rent
        - Technology - replaces employees = less wages + increased efficiency at cost of resistance to change
        - Budgets - allows for monitoring and controlling of costs

- Cost centres (large businesses)
    - Breaking up a business into organisational areas which have their own budgets and manage their own expenses

- Expense minimisation
    - Management action which decrees a certain ceiling on a particular cost
    - Eg. Blackmores 1H19 report - management wanted to reduce transport expenses by 15%

***Revenue Controls - sales objectives, sales mix, pricing policy***

- Sales objectives
    - Usually based on sales forecasts of future months and years. For example, the business can see that forecasts predict a 10% increase in sales, therefore more marketing is needed to reach this objective.

- Sales mix
    - Range of products & services offered by a business
    - Products with greatest profit margins and high growth potential developed while the slow moving and less profitable items are phased out

- Pricing policy
    - Aims to balance sales with profit
    - Discounting selling price may lead to increased sales but not necessarily increases in profitability
    - Low prices will encourage sales and market penetration but long-term cost needs to be covered adequately

    - ***Cash Flow Statement (monitoring and controlling)***

The cash flow statement and relevant strategies can mean the difference between solvency and administration, liquidation of assets, deregistering a company and ceasing trade.

Therefore, an understanding of the cash flow statement and its strategies is of prime importance to financial management. Cash inflows and outflows can be broken up into operating activities (everyday workings), investing activities (cash flow related to asset purchase/sale and projects) and finance activities (equity and debt cash flow and dividend payments).

- ***Cash Flow Management Strategies (strategies)***

- Cash flow statements
  - Number one strategy for any cash flow issue
  - By completing a cash flow statement, any cash flow issues can be identified
  - Another strategy can then be used to rectify discovered issue

- Distribution of payments
  - Large lump sum payments cause liquidity issues
  - Therefore large sum payments such as tax, insurance and multi-year leases for equipment and buildings can be broken up into smaller, regular payments.

- Discounts for early payments
  - Suppliers and government sometimes offer discounts for early cash payments. If a business takes advantage of this, they can lower the amount paid significantly. These usually range from 2-5%

- Factoring
  - Selling accounts receivables to obtain instant cash - up to 85% of the value of AR
  - Commonly used when cash flow is negative and turnover ratio is low
  - AKA invoice financing

- **Limitations of Financial Reports (processes)**

Capitalising Expenses
- This is the process of adding a capital expense like R&D from the income statement as an expense to the balance sheet as an asset (usually non-current). This leads to an overvaluation of the business as OE increases (net profit increase due to reduction in expenses)

Normalised Earnings
- Involves taking 'one-off' sales such as the sale of a premises and recording it on the income statement as regular revenue. This would skew the profitability of the business

Valuing Assets
- This is the process of estimating the dollar value of assets and liabilities. Predicting the future value of an asset is often overestimated whereas liabilities are often underestimated.
- Depreciation of assets should always be visible on the balance sheet

Timing Issues
- Involves delaying a large expense to the beginning of a new financial period rather than paying it at the end of the financial period when it falls due. This would show misleading profitability figures for the financial period

Debt Repayment
- If accounts receivables are not collected, the bad debt should be removed from the current assets, owner's equity and revenue. However, businesses usually hold off doing this for as long as possible

Notes to Financial Statements
- The notes section of every financial report is located at the end and addresses any of the above limitations however it can be very long and tedious to read. They are used to give explanation of why some of the above limitations occured in the financial statements

- **Ethical Issues (processes)**

Ethics refers to the standards of behaviour or moral position held by an individual or organisation which determines what decisions are made.

Management must continually consider the impact of their business' operation on shareholders and society in general. Businesses have an ethical obligation to act in the best interests of society. This obligation is not a law, however society will punish for unethical decisions

Audited Accounts

- An audit is an independent official examination of a business' accounts to establish truth and fairness. This minimises 'cheating'. Large businesses should have their accounts audited to prevent the misuse of funds and inappropriate limitations. The misuse of funds is prevented by developing an internal control system and through internally audited accounts. Limitations will be minimised with truthful information relaid to shareholders.

Record Keeping and Reporting Practices

- There is an ethical responsibility of business owners to accurately record all business transactions. Many businesses do not declare all cash receipts in order to reduce tax to impress shareholders. This is not ethical or legal.

GST Obligations

- If a business buys inputs and is charged GST by a supplier, they are able to claim credits on the amount as long as they pass on that expense to customers. Therefore it would be unethical and illegal to claim credits for amounts they don't pay. All GST collected must be passed on to the ATO.

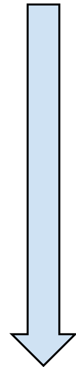
- **Financial Management Strategies (continued)**

- ***Global Financial Management***

- Methods of International Payment

Payme
nt in
advance

Letter
of credit
Bill of



There are four basic methods of international payment:

1. Payment in advance
2. Letter of credit
3. Bill of exchange
4. Clean payment

The option selected will depend on the importer's ability to pay (risk to the exporter)

1. Payment in advance
    a. Payment for goods is sent to the exporter before the goods are shipped. Once payment is received, goods are shipped.

2. Letter of credit
    a. Financing where a bank acts as an intermediary. After goods are shipped, the exporter sends documents to their bank who then sends the documents to the importer's bank. The importer pays their bank, the importer's bank pays the exporter's bank, the exporter's bank pays the exporter.
    b. A letter of credit is a ***payment mechanism (acts as confirmation to begin payment process)***

3. Bill of exchange
    a. A document drawn up by the exporter demand funds from the importer. Sent through banks again. The exporter maintains ownership of goods until funds are received.
    b. A bill of exchange is a ***payment instrument (dollar value like a coin)***

4. Clean payment
    a. The exporter delivers the goods and then invoices the importer (used only in long-term relationships)

- Interest Rates

Interest is the cost of borrowing money. Domestically, this affects debt financing and consumption in the economy. Globally, interest rates affect exchange rates as a higher interest rate attracts greater investment, pushing the exchange rate up.

- Exchange Rates

AUD falls:

- Imports are more expensive
- Exports from Aus are cheaper, Aus exporters become more competitive

AUD rises:

- Imports are cheaper
- Exports are more expensive, Aus exporters become less competitive

Changes in exchange rates affect:

1. Marketing decisions
    a. Whether to raise prices or maintain them during rate fluctuations
2. Production decisions
    a. Having production in/exporting from a weak currency country and sales in a strong currency country improves profitability
3. Financial decisions
    a. Exchange rates influence the cost of debt financing. As the AUD goes up, debt repayments overseas become less

- Hedging

Hedging is used to insure against currency fluctuations through derivatives. By entering a contract at the present time to buy/sell foreign exchange at a specified rate on a given future date, a business can plan around that future expense.

- Derivatives

Derivatives play a large role in global financial markets. These are securities whose prices are determined by or ‘derived from’ the prices of other securities. Options, futures and forward contracts, and swaps are all derived securities that are used differently by companies and financial institutions.

Forward contract

- A contract to buy one currency for another at an agreed rate on a future date. This cannot be revoked or backed out of.

Currency options

- Gives the buyer the right to, without obligation, buy or sell currency at a guaranteed rate in the future. This comes with upfront fees

Swaps

- An agreement to exchange currency during a specified period of time.