Chapter 1
Overview of Financial Management

REVIEW QUESTIONS

1. Explain the key difference between what financial management focused on in the past versus today.

   In the past, financial management focused primarily on external activities (e.g., raising money, acquisitions, legal matters), that is, one segment of the statement of financial position. Today, although the management of raising money from investors is still important, financial management has focused increasingly on the other segment of the statement of financial position, finding ways to manage more efficiently and effectively all assets of a business, that is, non-current assets and current assets.

2. What factors of the external environment have an impact on a company's financial statements?

   All external factors have an impact on a company's financial statements. They include economic activities, political activities, world economies, technological changes, industry activities, and efficiencies related to manufacturing activities.

3. Define financial management.

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

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

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

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

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

6. Why should operating managers be responsible for the finance function?

Managers are accountable for their decisions as they impact, directly or indirectly, the financial performance of their business unit or organization as a whole. They understand their operating environment, know exactly where they want to go, and have an appreciation about what needs to be done in order to reach their objectives.

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

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

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

The return on revenue financial objective impacts on the four financial objectives. *Efficiency* is improved since there is a direct connection between revenue and profit (costs as a percentage of revenue go down); *liquidity* is improved since more cash is available for spending on working capital such as trade receivables and inventories; *prosperity* is enhanced since more cash is also available for spending on all assets (current and non-current); and *stability* is also improved since more profit is added to the equity side of the statement of financial position.

9. Differentiate between internal financing and external financing.

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

10. What are investing decisions and financing decisions?

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

11. What are non-current assets?

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

12. What are working capital accounts?

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

13. What accounts in the statement of income and the statement of financial position are included in (a) investing decisions, (b) financing decisions, and (c) operating decisions?

    Investing decisions deal with non-current assets and other assets listed in the statement of financial position. *Financing decisions* involve non-current liabilities or long-term borrowings and a section of the equity account listed in the statement of financial position. *Operating decisions* deal with accounts listed in the statement of income and accounts related to current assets and current liabilities in the statement of financial position.

14. What is the weighted average cost of capital?

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

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

    An operating decision is a decision that affects the accounts included on the statement of income, such as revenue, cost of sales, distribution costs, and administrative expenses, and accounts in the statement of financial position such as inventories and trade receivables. Examples would include decisions related to looking for more efficient manufacturing methods, hiring additional employees, changing the level of advertising, and reducing the level of inventories and/or trade receivables.

16. What is gross profit?

    Gross profit is the difference between revenue and cost of sales.

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

    There are three key individuals responsible for finance in business: the treasurer, the controller, and operating managers. Operating managers are responsible for making important decisions related to the acquisition of assets (e.g., inventories, trade receivables, and non-current assets), and activities affecting the bottom line: cost of sales, distribution expenses, and administrative expenses. The more operating managers understand the finance function, the better are the chances that they will improve their decision-making skills and consequently, make more enlightened decisions.

18. What is transparency?

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

19. Differentiate between legislation and corporate governance.

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

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

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

LEARNING EXERCISES

EXERCISE 1: RETURN ON ASSETS AND COST OF FINANCING

Questions

1. If managers want to earn a 12% ROA, how much profit must the company generate?

   Generate $181,200 in profit ($1,510,000 × 12%).

2. If managers want to earn a 15% ROA, how much profit must the company generate?

   Generate $226,500 in profit ($1,510,000 × 15%).

EXERCISE 2: STATEMENT OF INCOME AND STATEMENT OF FINANCIAL POSITION

The italic fonts represent the missing accounts.

Statement of income

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

Statement of financial position

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

EXERCISE 3: DISTRIBUTION OF THE PROFIT FOR THE YEAR

Questions

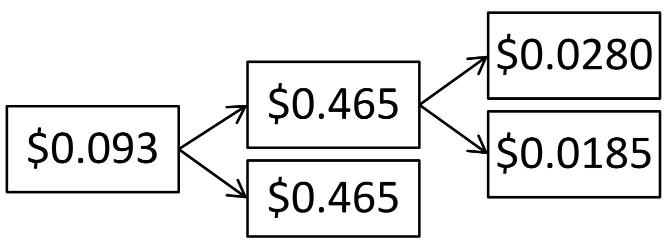
1. Calculate, as a percentage of revenue, how much would be kept in the company for growth (i.e., working capital and non-current assets) and how much would be used to pay dividends.

	in $	as a percentage of revenue
Revenue	3,000,000	100
Profit for the year	280,000	9.3

First split: (rounded)			
50% for retained earnings	140,000	or	4.65
50% for dividends	140,000	or	4.65
Total	280,000	or	9.3

Second split:(rounded)			
60% of retained earnings for non-current assets	84,000	or	2.8
40% of retained earnings for current assets	56,000	or	1.85
Total	140,000	or	4.65

The following gives a visual presentation of the above splits.



2. Explain who is responsible for deciding how much to retain in the business and how much to pay in dividends.

   The board of directors is responsible for making this type of decision.

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

   Some of the issues that would be discussed are:
   - invest more in the business in the form of working capital
   - invest more in the business in the form of non-current assets
   - pay more dividends to the shareholders
   - reduce the debt
   - invest in research and development

EXERCISE 4: BUSINESS DECISIONS

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

Financing decisions
• Change in long-term borrowings
• Share capital issue

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

EXERCISE 5: COST OF BORROWING AND COST OF CAPITAL

Questions

1. Calculate the company's after-tax cost of borrowing. It is 9.932%

Sources	Amounts (in $)	Weight	After-tax cost (%)	Weighted cost (%)
Trade and other payables	200,000	0.087	0.00	0.000
Short-term borrowings	250,000	0.109	5.50	0.600
Mortgage	500,000	0.217	5.25	1.139
Long-term borrowings	250,000	0.109	5.00	0.545
Share capital	300,000	0.130	16.00	2.080
Retained earnings	800,000	0.348	16.00	5.568
	2,300,000	1.000		9.932

2. Calculate the company's weighted average cost of capital. It is 11.613%.

Sources	Amounts (in $)	Weight	After-tax cost (%)	Weighted cost (%)
Mortgage	500,000	0.270	5.25	1.418
Long-term borrowings	250,000	0.135	5.00	0.675
Share capital	300,000	0.162	16.00	2.592
Retained earnings	800,000	0.433	16.00	6.928
	1,850,000	1.000		11.613

EXERCISE 6: CASH FLOW FROM INTERNAL OPERATIONS

Questions

1. How much cash will be generated from internal operations by the end of 2013?

Cash inflow from internal operations is $265,000.

In $	2012	2013	Cash flow
Trade receivables	250,000	275,000	(25,000)
Inventories	430,000	370,000	60,000
Profit for the year		230,000	230,000
Total cash inflow			265,000

2. Will the owners have to borrow from investors to finance the expansion? If yes, how much?

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

Investing activities in January 2014	$550,000
Cash flow from operating activities in 2013	265,000
Financing required	$285,000

CASE
PACKARD INDUSTRIES INC.

Questions

1. Calculate the company's return on total assets for 2012.

The return on total assets in 2012 is 16.3% ($280,000 ÷ $1,720,000).

2. How much cash will be provided by internal operations in 2013, in particular by the following?
   - Retained earnings
   - Inventories
   - Trade receivables

   Internally generated cash from operations in 2013 is $419,600.

Profit for the year (retained earnings)	$369,600
Inventories	20,000
Trade receivables	30,000
Total cash generated internally	$419,600

From retained earnings

2013 Revenue	$3,080,000 ($2,800,000 × 10% growth)
2013 Profit for the year	$369,600 ($3,080,000 × 12% ROR)

From inventories

Cash provided by inventories:

2012	$300,000
2013	280,000
Difference	$ 20,000

From trade receivables

Cash provided by trade receivables:

2012	$400,000
2013	370,000
Difference	$ 30,000

3. How much will management have to raise from external activities (shareholders and lenders) to proceed with an $800,000 investment in non-current assets?

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

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