HSC Business Finance Notes

Role of financial management

Strategic role of financial management

→ To plan and monitor the business's financial resources to enable the business to achieve its financial objectives, both in the short and long term.

→ Financial management involves two key elements:

- ❏ Accounting: systems and processes to oversee financial transactions
- ❏ Finance: the sourcing and management of funds from a variety of sources

→ tasks involved in financial management

- ❏ Maintaining and reporting information about the firm's financial position
- ❏ Forecasting future financial outcomes
- ❏ Distributing financial resources to various business functions
- ❏ Acquiring additional financial resources

Objectives of financial management

→ The objectives of financial management include short term (>12 months) and long term goals (<12 months).

→ Short term goals include liquidity and long term include profitability and efficiency.

→ profitability = revenue - expenses

- ❏ Most decisions business make will be to maintain/increase profit margins
- ❏ Profit Maximisation is when profit margin is as high as possible and occurs through decreasing expenses or increasing revenue
- ❏ Without profit businesses may struggle to pay expenses and risk closure

→ liquidity

- ❏ how quickly a business can turn their assets into cash
- ❏ All firms need a certain amount of liquid assets to manage short term operations
- ❏ Firms can gain liquidity by selling and leasing assets.

→ efficiency

- ❏ using the business's resources to minimise expenses to therefore raise profit
- ❏ Using the least possible resources to effectively achieve a desired outcome
- ❏ Less time and money spent on unnecessary expenses = more time for other goals

→ growth

- ❏ is increased market share, product range, sales and value of assets
- ❏ Growth ensure future profitability in the long term
- ❏ Can be achieved through expanding location, merging with competitor or more products

→ solvency

- ❏ ability to pay long term finances (repayments)
- ❏ Important for owners, shareholders and creditors as it indicates the risk of investment
- ❏ A business with high debt levels and declining revenue is at a risk of insolvency

- A figure quite low might indicate a business not taking full advantage of its capacity to use borrowed funds to expand its operations
- A figure too high suggests the business has too great reliance on debt funding

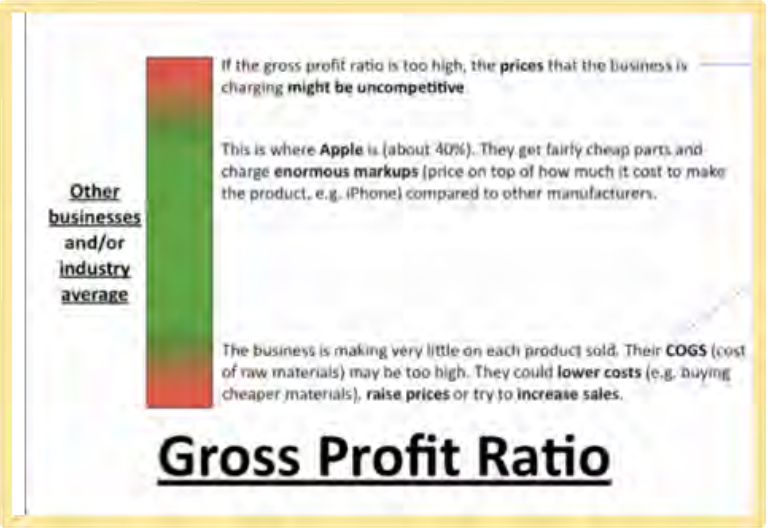
❑ The business must also consider the industry average when interpreting performance

❑ Strategies to improve gearing ratio
- Decease debt levels
  - ➢ Sell stock to pay off overdraft
  - ➢ Collect accounts receivable (via factoring) and use this cash to pay total liabilities
  - ➢ Use cash to pay off TL
- Increase equity levels
  - ➢ Owner can inject more capital (increase total equity)
  - ➢ Increase retained profit by reducing expenses (wages, advertising)
  - ➢ Increase retained profit by increasing sales (using 7P's)

→ Profitability

❑ Profitability → the earning performance of the business and indicates its capacity to use its resources to maximise profits

❑ Gross profit ratio
- Gross Profit/Sales X 100
- The ratio determines the percentage of each dollar of sales that is gross profit
- A GPR of 50% means that for every $1 Of sales the business is making gross profit of 50c
- High GPR are preferred but must be compared to previous years and industry figures



- Strategies to improve Gross profit ratio:
  - ➢ Increase price of sales → generates higher sales revenue (price X quantity)
  - ➢ Increase number of sales → generates higher sales revenue (7P's + interdependence)
  - ➢ Decrease COGS by obtaining stock at lower prices → reduces cost of the expense of buying + holding stock (may compromise quality)

❑ Net profit ratio
- Net profit/sales X 100
- The ratio determines the percentage of each dollar of sales that is net profit
- A NPR of 20% means that for every $1 of sales, the business is making a net profit of 20c

Currency Appreciation	Currency Depreciation
An upward movement of the Australian dollar against another currency (eg if the value of the AUD rises from US$0.70 to US$0.95)	A downward movement of the Australian dollar against another currency (eg if the value of the AUD decreases from US$0.70 to US$0.50)
Profits made in Aus by global companies will increase in value when converted back to local currency	Profits made in Aus by global companies will decrease in value when converted back to local currency
Each unit of foreign currency buys fewer Australian dollars	Each unit of foreign currency buys more Australian dollars.
Exports from Australia to other countries become more expensive. Aus business exporting overseas (eg coal) may make fewer sales which decreases revenue	Exports from Australia to other countries become cheaper Aus business exporting overseas (eg coal) makes increased global sales which increases revenue. Allows for growth.
Imports from other countries into Australia become cheaper. Aus businesses buying raw materials or supplies from cheap overseas countries WIN. Cheaper global imports mean less expenses	Imports from other countries into Australia become more expensive. Aus businesses buying raw materials or supplies from overseas countries LOSE - more AUD required for same global input; reducing profitability
Reduces international competitiveness	Improves international competitiveness

→ interest rates

- When borrowing money domestically or internationally, the cost of borrowing is interest.
- More Australian businesses are sourcing funds from overseas.
- This is because Australian interest rates tend to be higher. However, there are risks involved in borrowing funds in a different banking system.
  - Less regulatory authorities ensuring adequate protection
  - Loan repayments which are paid in the foreign currency
  - Adverse currency fluctuations could see the advantage of cheaper overseas interest rates costing more in the long run.

→ methods of international payments

Method	**Explanation**	**Exporter/Seller risk**	**Importer/buyer risk**
Payment in advance	Seller doesn't ship the product until full payment is received.	Most secure, least risk	Highest risk least secure
Clean payment	Exporters ship goods directly to the importer before payment is received. Goods are usually shipped with an invoice requesting payment at a certain point after delivery	More secure as it reduces risk for exporter as the bank takes on payment risk	High risk, less secure if terms of document not met
Bills of exchange	Document drawn up by the exporter's bank demanding payment from the importer at a specified time. This method is one of the most widely used and has strict international laws governing its use	Less secure, but risk reduced for exporter as they can communicate directly between their bank and the buyer's bank	More secure as the responsibility to pay is after the goods have been sent