Financial Management

Learning Objectives

- Meaning of financial Management
- Functions of Financial Manager
- Sources of Finance and types of Finance
- Basics of Loan Amortization, mortgages, and Sinking fund and Mutual Fund
- Factors to consider in Choosing Source of finance
- Problems of sourcing for funds
- Cash Management
- Credit Management
- Working Capital Management

Meaning of Financial Management

- Financial management has two aspects: the Financial and Management dimension.

- The financial aspect deals with **all resources in terms of money**

- The management aspect refers to the means planning, organizing, directing and controlling the financial activities such as **procurement** and **utilization of funds** of the enterprise.

- It means applying **general management principles** to **financial resources** of the enterprise.

- It is also referred to as **Business/ Corporate Finance**

Key Issues in Finance

The basic issues in finance are essentially the same for diverse businesses. The **key issues** are:

1. Where to raise financial resources from?

2. Wherein to invest the resources?

3. How much of profit to distribute and how much to retain?

Objectives of Financial Mgt

- To ensure regular and adequate supply of funds to the business concern.
- To ensure optimum funds utilization. Once the funds are procured, they should be utilized in maximum possible way at least cost.
- To ensure safety of investment, i.e., funds should be invested in safe ventures so that adequate rate of return can be achieved.
- To plan a sound capital structure-There should be sound and fair composition of capital so that a balance is maintained between **debt** and **equity capita**l.

Objectives of Financial Mgt

- To maximize the wealth of shareholders
- To minimize operational risk
- To help management determine and assign costs to various sources of finance
- To provide information for management planning and controlling growth and expansion
- To survive and avoid financial distress

Functions of Financial Manager

1. Evaluate and control capital projects of the firm
2. Assess and manage possible business risks
3. Plan and allocate funds required for working capital
4. Evaluate financial alternatives
5. Strategize acquisition and mergers programmes for external growth and expansion of the firm

Functions of Financial Manager

6. Forecasts the requirement of funds for both short-term and long-term purposes.

7. Actively take part in budgeting, risk management and financial reporting.

8. He decides what type of capital structure is required by the company and decides whether to raise funds from loans or from share capital.

9. He also ensures that adequate funds at cheap rates are supplied to various parts of the organization at the right time.

Functions of Financial Manager

10. He makes financial reports and have an eye on profits and losses.

11. He constantly reviews the financial performance of various units of the organization.

12. He also ensures that no excess cash is lying idle.

The basic Decisions in FM

Financial decision-making involves procurement of funds and their optimal utilization through:

1. Financing Decisions
2. Investing Decisions
3. Dividend Decisions

Financing Decisions

It is also referred to as capital structure decision. It is concerned with:

1. Identifying the suitable sources of funds
2. Tapping of these sources.

The main thrust is to bring down the cost of financing.

The main issues involve:

1. Where to procure the requisite funds?
2. What should be the optimal mix of various sources of capital?
3. How much should be the proportion of short-term and long-term funds?

Investing Decisions

- It is also called capital budgeting decisions.
- It aims at selecting the most productive avenues that maximize the ROI.
- Business investment objectives include: expansion, modernization, replacement and R&D
- They are critical for long-term survival and growth

- The features of these decisions include:

1. It involves huge capital outlay
2. It has long-term implication
3. It is usually irreversible

Dividend Decisions

- It is concerned with deciding the mix of profits to be distributed as dividends and those to be ploughed back for future financing needs of business.
- It depends on trade-off between future financing needs of the firm and current consumption requirements of the shareholders.
- The payout ratio is decided in the light of its probable impact on shareholders' wealth

Sources of Finance

- This is a financing decision a firm needs to make in order to operate efficiently and effectively.

- The sources can be categorized as:

1. Internal or external sources

2. Short-term or long-term sources

- Internal sources are funds that comes through the internal operations of the business. E.g. Retained profits.

- External sources are funds that come **outside** the organization such as debts and shares.

Sources of Finance

Short-term sources are needed for **day-to-day** expenses of doing business such as paying wages and salaries, purchase of inventory, etc. **E.g**. Trade credits, bank loans, bank overdraft, debt factoring etc.

Long-term Sources are finance needed for expenditure on fixed assets such as land, plant, and equipment necessary for conducting business. E.g. Long term funds can be shares, debt capital, leases, mortgages, loan term loans, hire purchase

Types of Short-Term Finance

- **Trade Credit**: This is regarded as the basic source of finance and arises as a result of credit purchases. With this source, goods are ordered and delivered before payments are made.

- **Factoring**: It involves raising funds on the security of the company's debts, hence cash is received earlier than if the company waits for customers to pay. The provider takes control of the sales ledger, credit control and chasing customers for the settlement of their invoices.

- **Invoice discounting**: Is also a financial arrangement which benefits the liquidity position of the enterprise. The essential difference between invoice discounting and factoring lies in who takes control of sales ledger and responsibility of collecting payment (the business does).

Types of Short Term Finance

- **Bank overdraft**: This is one of the most common used sources of short-term finance in relation to cost and flexibility. They can quickly and easily be paid when borrowed funds are no longer required.

- **Counter trade**: It is a method of trade financing, but goods rather than money are used to fund the transaction. It is a form of barter.

Types of Short Term Finance

- **Bank lending** is still mainly short-term, although medium-term lending is quite common in recent times. Short-term lending may be in the form of overdraft.

- **Hire purchase**: Is a form of instalment credit. It is similar to leasing, with the exception that ownership of the goods passes to the hire purchase customer on payment of the final credit instalment. However, a lessee never becomes the owner of the goods.

Types of Short Term Finance

- **Leasing:** A lease is an agreement between two parties, the "lessor" and the "lessee". The former owns a capital asset but allows the latter to use it. The lessee therefore makes payments on the terms of the lessor for a specified period of time.

- **Government assistance**: Government provides cash grants to companies and other direct forms of assistance, as part of its economic policies. E.g. The Revolving Loan Scheme of NBSSI in 1992.

- **Venture capital**: This is money invested into an enterprise which may be lost on the failure of the business.

Types of Long Term Finance

- **Shares:** A share is a part ownership of a company. They relate to Private limited companies or Public limited companies.

Types of Shares

- Preference shares: These shares have a fixed percentage dividend before any dividend is paid to the ordinary shareholders.

- Ordinary shares: are shares on which dividends are paid if sufficient distributable profits are available.

Merits of Preference Shares

To the company;

- Dividends do not have to be paid in full in a year which profits are poor (not the case with loans or debentures).
- With the absence of voting rights, preference shares avoid diluting the control of existing shareholders.
- Unless redeemable, preference shares issue will lower company's gearing.
- Issue of preference shares does not restrict the company's borrowing power.

Demerits of Preference Shares

To the Investor:

Preference shares are less attractive than loan stock because:

- They cannot be secured on the company's assets.
- The dividend yield traditionally offered on preference dividends are comparatively lower than interest yields on loans in view of the additional risk involved.

Types of Long Term Finance Cont'd…

- **Loan stock**: This is a long-term debt capital raised by a company for which interest is paid at a fixed rate. Holders of loan stock are considered long-term creditors of the company.

- **Debentures** are also a form of loan stock. They are a written acknowledgement of a debt incurred by a company with repayment terms. They are secured by a fixed or floating charge.

Types of Long Term Finance

- **Bank Loans:** Banks may lend sums over long periods of time-possibly up to 25 years or even more in some cases. Loans have a rate of interest attached to them and this can vary with respect to the way the Bank of Ghana sets them.

- **Mortgage**: A mortgage is a loan specifically for the purchase of property. Businesses do buy property through mortgage and such property is usually used as security for the loan.

Types of Long Term Finance

- **Owner's capital**: As the name suggests, these are monies invested into a business by the owner(s). Such monies can accrue from savings, inheritance or money received from redundancy payment.

- **Retained profit**: This is a source of finance that would only be available to a business that was already in existence. In the early stages of business growth, it may be necessary to put back lots of profits into the business.

Types of Long Term Finance

- **Selling assets:** Growing firms build up assets in the form of property, machinery, other companies or even logos.

- It becomes appropriate sometimes or in some cases for a business to sell or dispose off its assets to finance their activities.

The 5Cs of extending loans

Lenders often use the five C's of credit to determine which credit or loan requests will be approved and which will be rejected.	
Factor to Consider	**Description of Why This Factor Is Important**
Character	The borrower's attitude toward credit obligations
Capacity	The financial ability to meet credit obligations—that is, to make regular loan payments.
Capital	The term *capital* as used here refers to the borrower's assets or the net worth of the individual or business applying for a loan.
Collateral	Real estate or property including stocks, bonds, equipment, or any other asset pledged as security for a loan.
Conditions	General economic conditions that can affect a borrower's ability to repay a loan or other credit obligation.

Loan Amortization

- Amortization is the **gradual repayment** of a **debt over** a period of time, such as monthly payments on a mortgage loan or credit card balance.

- To amortize a loan, your payments must be large enough to pay not only the interest that has accrued but also to reduce the principal you owe. The word amortize means "to bring to death."

Sinking Fund

- It is a fund or account into which a person or company deposits money on a regular basis in order to repay some debt or other liability that would come due in the future.

- For example, if one wishes to finance the daughter's university education worth GHS 9000 in 10 years time, one may put money into a sinking fund for ten years in order to be ready to pay off the principal when it comes due.

Factors to Consider in Choosing Source of Finance

1. Length of time for which funds are needed

2. Cost of raising the finance in one way rather than another

3. Flexibility of the finance

4. Retention and diffusion of control of the business

Problems of Sourcing for funds

1. The absence or inaccessible financial information.
2. Lack of governmental and institutional support in the financial sector.
3. Cumbersome requirement for sourcing for funds particularly from the banks.
4. High financial illiteracy among the majority of people.
5. High interest rate charged for borrowing money.

Cash Management

- Cash management is concerned primarily with the optimization of the amount of cash available while maximizing the interest earned by spare funds not required immediately.

- Holding cash in order to meet short term needs incurs an opportunity cost equal to the gains which could have been earned if the cash had been put to a productive use.

- However, by operating with small amount of cash balance the organization will increase the risk of being unable to meet debts as they fall due. So it is necessary that an organization holds an optimum cash balance

Motives for Holding Cash

- **Transaction motive:** Organizations need cash reserves to be able to purchase goods and services. They need the cash to balance the short term cash inflows and outflows.

- **Precautionary motive:** Organizations keep some cash reserves to avoid unexpected demands for cash in the short term. They just take precaution. Reserves for precautionary motives maybe in the form of easily realized short term investments (e.g. near cash items, treasury bills).

- **Speculative motive:** This is the motive of holding cash reserves so that the business can take advantage of any attractive investment opportunities that may arise.

Cash Budget

Cash budget incorporates estimates of future inflows and outflows of cash over a short term period of time projected. The period may usually be a year, half a year, or quarter year.

What is cash flow?

Cash flow is the measure of an organization's ability to pay bills on a regular basis. It depends on the amount and timing of money flowing into (cash inflows) and out (cash outflows) of the the business each week, month, quarter or year. Good cash flow allows a business to pay its bills on time.

Determining Optimum Cash Levels

Whether it is a small organization or a big one, the optimum amount of cash held will depend on the factors listed below:

- The forecast of future cash inflows and outflows
- The efficient management of cash flows
- The availability of liquid assets to the organization
- The availability and borrowing capability of the organization and
- The organization's risk appetite (i.e. the organization's tolerance of risk

Cash Flow Problems

There are number of reasons why an organization may experience cash flow problems. They include the following:

- Poor credit controls
- Failure to fulfill your orders
- Poor management accounting
- Inadequate supplier management
- Ineffective ordering services
- Poor marketing
- Poor control of overheads

Remedies to Cash Flow Problems

- Postponement of expenditures
- Acceleration of the rate at which cash flows into the business by, for instance, offering discounts for early payments to customers
- Selling and converting into cash investments that were probably bought with the surplus cash from previous period
- Postponement or reduction of cash outflows by delaying to pay suppliers and by rescheduling loan payments
- Reduction, or stopping altogether, of dividend payments

Credit Management

In most business-to-business purchases, companies extend credit facilities to their customers. Credit is a crucial tool for attracting and keeping customers.

However, if not well managed, credit facilities can affect cash flow management. Poorly managed credit, for instance, can result in delays in converting sales into cash.

Reading Assignments:

1. Meaning and types of credit policy
2. Determinants of Credit Policy

Management of Working Capital

All organizations, especially businesses, have to consider the management of working capital as vital to their operations and success.

Reading Assignments:

1. Objectives of Working Capital Management
2. Level of Working Capital
3. Advantages of Adequate Working Capital
4. Disadvantages of Excessive Working Capital
5. Dangers of Inadequate Working Capital, etc