Introduction to Business II

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Financial Management

Learning Objectives

- Meaning of financial Management
- Functions of Financial Manager
- Sources of Finance and types of Finance
- Basics of Loan Amortisation, mortgages, and Sinking fund and Mutual Fund
- Factors to consider in Choosing Source of finance
- Problems of sourcing for funds
- Why businesses fail Financially
- Issues in Personal Finance

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 essential the same for diverse businesses. The **key issues** are:

1. Where to raise financial resources from?
2. Wherein to invest the resources?
3. How best to manage the production-distribution function?
4. How much of profit to distribute and how much to retain?

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 refers to as capital structure decisions.

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 from 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 aims at selecting the most productive avenues that maximize the ROI.
- Business investment objectives include: expansion, modernization, replacement and R&D
- It is also called capital budgeting decisions.
- 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

Objectives of Financial Management

- To ensure regular and adequate supply of funds to the 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 on 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.
- To maximize the wealth of shareholders

Objectives of Financial Management

- 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 risk
3. Plan and allocate funds required for working capital
4. Evaluate financial alternatives
5. Strategize the acquisition and mergers programmes for external growth and expansion of the firm
6. Forecasts the requirement of funds for both short term and long term purposes.
7. Actively takes part in budgeting, risk management and financial reporting.

Functions of Financial Manager

- He decides what type of capital structure is required by the company and decides whether to raise funds from loans/borrowing or from share capital.
- He also ensures that adequate funds at cheap rates are supplied to various parts of the organization at the right time.
- He makes financial reports, have and eye on profits and losses, etc.
- He constantly reviews the financial performance of various units of the organization.
- He also ensures that no excess cash is lying idle.

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. Eg. Retained profits.
- External sources are funds that come **outside** the organization such as debt 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

Question: what is the difference between Preference and Equity shares

State three secured source of finance

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 itself tells the story, since it means "to bring to death."

Mortgages

- It is a loan to finance the purchase of real estate, usually with specified payment periods and interest rates.
- The borrower (mortgagor) gives the lender (mortgagee) a lien on the property as collateral for the loan. The mortgagor's lien on the property expires when the mortgage is paid off in full.

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 will 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.

Sinking Fund

- A sinking fund is a fund established by a government agency or business for the **purpose** of reducing debt by repaying or purchasing outstanding loans and securities held against the entity.
- It helps keep the borrower liquid so it can repay the bondholder.

Mutual Funds

- A mutual fund is a company that brings together money from many people and invests it in stocks, bonds or other assets.
- The combined holdings of stocks, bonds or other assets the fund owns are known as its ***portfolio***. Each investor in the fund owns shares, which represent a part of these holdings.

Advantages Of Mutual Funds

- Less risky
- Requires little amount of money for investment purposes
- Access to professional management of your funds
- They are more liquid

Factors to Consider in Choosing Source of Finance

1. length of time for which they need the finance
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

Question

Outline the advantages of debt finance over equity

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.

Why firms fail Financially

1. Not enough funds to start with
2. Poor control over cash flow
3. Inadequate expense control
4. Failure to collect cash from credit customers
5. Accumulated tax obligations
6. Unfavourable market conditions

Issues in Personal Finance

This issues are problems that requires answer

Issue 1: spending without knowing your limits

Question #1. What is my disposable income? (that is your total income less taxes)

Question #2. What do I need to spend to live?
Question #3. What is the difference after taking spending from income?
Question #4. Can I save enough for my future from the answer in Question #3

In economics **$Y = C + S$**

Issues in Personal Finance

Issue 2: spending without setting saving targets

- If you set a target of **x %** of your disposable income each payday that would be a good start.
- In the Book of the *Richest Man in Babylon*, George Calson suggested the following:
- **Pay yourself first. 'Wealth, like a tree, it grows from a tiny seed.** The first copper you save is the seed from which your tree of wealth shall grow. The sooner you plant that seed the sooner shall the tree grow.
- **Faithfully nourish and water that tree with consistent savings**

Issues in Personal Finance

Issue 3: spending without knowing to save

1. *Don't buy on impulse*. Ask yourself 2 or 3 times "Do I really NEED this?" before you buy. If you cannot answer with a resounding "YES " let it go.
2. *Don't buy things JUST because they are on sale*. Only buy things you need.
3. *Don't buy the latest fashion items at the height of the season*. Just wait a while. The prices usually reduce.
4. *Don't compare yourself with others and what they have*. They may have purchased making the same finance mistakes as you.
5. *Set yourself a savings target*. Put this money aside each payday before spending any of your pay.

Issues in Personal Finance

Issue 4: spending without caring about the future

Unless you are planning for your future and financial security, you **cannot be really happy**.

There are always **worries lurking in your mind** about how you would survive in a financial emergency if you have no savings.

It can be very rewarding to see how quickly your savings multiply over time with only a small investment each payday.

Issues in Personal Finance

One Ghana for your Pocket

- Did you know that by saving just GHS1 every day for 365 this would grow into GHS 383.25 in 12 months at 5% interest, *ceteris paribus*.
- It then grows if you continually save the same GHS 1. You stand the chance of obtaining whopping amount of about GHS 1652 in 4 years?
- Isn't your future worth investing in? Think about it.

Budgeting

- Personal finance calls for budgeting
- Thus, in simple terms, one must understand how to balance the income with the expense.
- The effect of the balancing is either a surplus and deficit.

Importance of Budget in Personal finance

1. Budgets help people see where their **money goes.**
2. Budgets help people **save** towards particular goals.
3. Budgets help people from getting too **deeply into debt**.
4. Budgets help people plan their spending so they can buy the **goods and services they really need**.
5. Budgets help people **save** so that they can then **invest the spare funds** and **earn more income**.

FOOD FOR THOUGHT

- **“Most people fail to realize that in life, it’s not how much money you make, it’s how much you keep”** by Robert T. Kiyosaki.
- **We buy things we don’t need, with the money we don’t have just to impress people we don’t like.**
- **“If you find yourself in a hole (debt), stop digging (borrowing), Debt is a trap”**. By Robert Kiyosaki.
- ***We are what we repeatedly do.’ By Aristotle.***
- *Hence make money making a habit*