Financial Management

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Introduction

This covers the foundations and roles of financial management within a *limited* company, including the role of a financial manager, with some working examples. When you buy something as a person, you consider the source of the money, what else that money could be spent on (ie. prioritisation of spending) and the value for money that you're going to receive. Businesses do the exact same, just on a larger scale.

1 Overview

Financial Management decisions can be categorised as either *financing* decisions, which is where the money comes from, or as *investment* decisions, which is what the money is going to be spent on. In reality, financial management is performed by two people in a company: the **Finance Director** (who manages long-term strategic financial decisions) and the **Corporate Treasurer** (who manages day-to-day finances) but this module doesn't go too far into the ins and outs of that.

As for financing, example finance sources include sales revenue (of either goods or services), interest from money the company holds, bank loans, and things like investments into other companies. All these sources can be classified in two different ways: **internal/external** finance, and **long term/short term** finance.

2 Long/Short Term

There isn't a strict definition on what constitutes long or short term finance, but the general idea is that any finance that is on timescales shorter than a (financial) year is short-term, and anything longer is long-term. However, if an initially short-term type of finance develops, it might become a long-term source (eg. if it is used repeatedly, such as a repeated short-term loan). There are three things to consider when choosing which type of finance to use:

- Matching the type and source of the borrowing with the nature of the assets you intend to acquire with it. Long-term borrowing is appropriate for financing permanent assets, and short-term borrowing to meet goals that cease to be relevant within a few weeks or months.
- Short-term financing/borrowing is the only type that should be used to satisfy short-term flexibility, such as working around variable interest rates, or to postpone a long-term commitment.
- Finally, there is innate risk in long-term borrowing. If you get a large loan out and intend to pay it back over a long duration, the bank intends to make a certain amount of profit from interest. However, if you acquire the means to pay the loan back early, you may be still required to pay back additional interest. Hence, if the company is aware (and certain) that an additional source of income is on the horizon (ie. no longer than a year) then short-term borrowing may be more appropriate. However, if the company finds itself frequently renewing short-term loans, eg. due to unpredictable shortage of funds, then it might make more financial sense to just loan a larger sum for a longer period.

Hence, some things to consider when deciding between short- and long-term finance:

- Match the type of borrowing with the nature of the asset you require. Long-term for something integral to the corporation, short-term for funding local fluctuations.

- Match the *lifetime* of the asset with the duration of the finance.
- Short-term finance might be considered in anticipation of falling interest rates, or high seasonal fluctuation of interest rates.
- Arrangement fees and penalties are higher with short-term loans.
- Interest rates are intrinsically higher for short-term loans.

3 Operating Cash Cycle

There are 4 steps of (external) finance within a company:

1. Purchasing goods (such as raw materials) on credit (ie. owing other companies for what you purchased.)
2. Payment of those goods.
3. Sale of goods on credit.(ie. other companies owing you for what they purchased.)
4. Being paid for those goods.

The duration between (1) and (3) is the *stockholding period*, ie. when you actually own something tangible (goods). The duration between (2) and (4) is the *Operating Cash Cycle*, ie. the duration between paying for goods, and receiving something for what you did with those goods. Longer OCCs are risky and have greater financial requirements, so companies aim to minimise the OCC.

A *current asset* is something turned over within one Operating Cash Cycle (or within a year) and includes:

- Actual money.
- *Receivables* and *Prepayments* (covered further down)
- Inventory
- Assets held for sale.

Basically, this includes anything that is either money, is equivalent to money, or conserves the spending of money within the organisation.

4 Internal vs.External

This section concerns the source of the finance. Generally, internal finance is preferred in almost all cases. Internal sources of finance require no agreements to take place, except internally within the company (ie. between managers and financial directors). External sources may require agreements between shareholders and the directors of the company. The major internal source of finance is earnings (revenue) from the current OCC, and retained profit from previous OCCs that wasn't redistributed to shareholders as dividends.

Shareholders generally expect some profit of each OCC to be paid out to them as dividends, as you'd be put off if the company was doing well and you had nothing to show for it. Hence, businesses generally split the money between shareholders, and retaining it for future investments, with the proportion depending on how well the company does, and how much it expects to need for investments in the near future.

Using pre-acquired internal finance is easier than acquiring new capital as it's basically already with the company. This means minimised administration fees and loan arrangement fees. Shareholders may also be happier with the tax advantage of using pre-acquired funds rather than distributing it among shareholders (companies generally distribute less than half of their profits to shareholders). Finally, using internal finance means minimal delay in receiving the funds (as the money is basically already there) and also less scrutiny from outside companies/auditors, as everything happens within the company.

5 Internal Short-term Finance

One of the most important types of finance is that which is both internal and short-term. There are three financial sources which fall under this domain:

Receivables - this is tighter control over companies who owe you money.

Inventory - physical goods which you own.

Payables - intelligently managing money you owe to other companies.

These three tie together to form **working capital management**, which is fancy terminology for pushing around money which doesn't (yet) actually exist. It's strictly a short-term source of finance, and the name itself (*"working capital"*) suggests you're basically trying to minimise the amount of money you are owed (and minimise the time for which you are owed), trying to turn over your inventory as quick as possible (so you don't have tangible stuff sitting in place, losing value), and postponing the repayment of debts to other companies for as long as possible to eke out just a little bit more money in the short term.

5.1 Receivables

Receivables are basically claims to future ownership of cash. The common form is trade-based receivables, which generally occur if you sell something, and bill for it later on (*"account receivable"*). Additionally, if a company fails to pay this when it is due, it becomes a *"note receivable"*, which unlike the former, will incur interest. Non trade-based receivables include everything not incurred through sale of goods, eg. from interest on current funds.

The **liquidity** of trade receivables is the amount of time that a sales, on average, remain classified as a receivable - ie. how long it takes to actually get money from selling something. Intelligent policies should be enacted to reduce liquidity of trade receivables and hence reduce tied-up funds, while also not being off-putting for your customer. This may include limiting how much customers may owe and how long they may owe it for, while also being both realistic and competitive. These must be closely monitored using accounting ratios, in order to ensure your restrictions are optimal - if other companies are more lenient then everyone will just use them instead. Finally, it might also be worthwhile to run credit background checks, check their past history with their own payables (ie. other company's receivables), and just generally vet them to assess the likelihood you will ever see the money you need.

Due to the cost of capital, there is also a cost associated with allowing longer liquidity durations. However, customers may be unwilling to pay earlier, so one way of offsetting this would be to pay a *prompt settlement* discount if a customer pays early. If this discount and the durations are balanced carefully, it's possible to save money by offering the discount. For example, take the scenario where annual sales are Âč12000, and the company offers repayments over 60 days. Assume the cost of capital is 10%. Could the company make a saving if they truncated the liquidity period to 30 days, but offered a prompt settlement discount of 0.8% if paid back within the reduced timespan?

The current cost to the company per year is:

$$12000 \times \frac{60}{365} \times 10\% = 197.26$$

However, the associated cost of the 40-day repayment (with the 3% discount paid to the customer) is as follows:

$$12000 \times \frac{30}{365} \times 10\% + 12000 \times 0.8\% = 194.63$$

The saving is not massive in direct terms, but if you look at this beyond face-value, not only would your money be tied up (liquidated) for a shorter duration meaning you have more time free to actually use it, but your customer sees a small discount on the repayment (ie. 0.8% of the repayment).

5.2 Payables

What you want your debtors to do to you, is basically the opposite of what you do to your own creditors. In contrast to receivables, payables involves paying as little back as possible, as late as possible. It's essentially free credit, so you want to exploit it as far as you possibly can - you might want to use things like the **average settlement period** accounting ratio as a policy to help you do this. Payable management is the area in which small businesses often lack the most - their accounting department is often unskilled in working capital management and hence can be pushed around by large companies who have the expertise to delay payment as far as they reasonably can, and small businesses cannot do likewise to compensate for this.

It's not all free money, though - there are costs of late repayment that must be carefully considered. If you consistently push your boundaries as far as possible, you might gain a reputation as a late repayer, which might mean companies are unwilling to give you a long period to repay the debt, or you might lose prompt resettlement discounts or have other restrictions imposed upon you. Not only this, but the administration cost of extending payment too far might also become an issue.

This isn't to say that working capital management shouldn't be done with payables, however. You put yourself at a useless disadvantage if you don't utilise it effectively: it's essentially interest-free credit, and by not using it, you lose some purchasing power, and the convenience of paying back at a more convenient time (eg. when you finally obtain the cash from another receivable you've been waiting on).

5.3 Inventory

Manufacturers generally have three categories of inventory: *raw materials*, *work-in-progress goods*, and *finished product*. Regardless of the type, you want to minimise the amount of time it's sitting around not being used or sold - inventory can represent a large percentage of the total assets of a company and can vary considerably on a seasonal basis, and with supply and demand, scarcity of raw materials, etc. Generally you want to minimise inventory levels, but not excessively so. There are negatives to having both too high, and too low, inventory levels.

If inventory levels are too high, your expenditure for holding costs, shipping and handling, and insurance increases. You risk potential losses to physical theft, as well as the innate losses of administration for managing your inventory. Not to mention the cost of your inventory depreciating, deteriorating or becoming obsolete while it's just there waiting, which is especially important for industries like electronics, food, and chemicals.

If inventory levels are too low, however, you suffer delays and potential losses of sale when you work to produce more inventory upon demand, which can cause inefficient production processes. You also lose the flexibility to take advantage of immediate business decisions and opportunities.

Hence, all in all, it's attractive to reduce inventory levels to make funds available for other purposes, but sufficient inventory levels must remain to meet business demand.