Overview of Financial Management

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Definition

- Financial Management entails planning for the future for a person or a business enterprise to ensure a positive cashflow. It includes the administration and maintenance of financial assets. Besides, financial management covers the process of identifying and managing risk.
The goal of financial management

- The goal of financial management is to maximize the current value per share of existing stock.
Financial Goals of the Corporation

- The primary financial goal is shareholder wealth maximization, which translates to maximizing stock price.
  - Do firms have any responsibilities to society at large?
  - Is stock price maximization good or bad for society?
  - Should firms behave ethically?
Factors that affect stock price

- Projected cash flows to shareholders
- Timing of the cash flow stream
- Riskiness of the cash flows
Developments in Financial Management

- Early 1900s - emphasis was on the legal aspects of mergers, the formation of new firms, and the various types of securities firms could issue to raise capital.

- During the depressions of the 1930s - emphasis shifted to bankruptcy and reorganisation, to corporate liquidity, and to the regulation of security markets.
Developments in Financial Management

- During the 1940s and early 1950s – finance continued to be taught as a descriptive, institutional subject, viewed more from the standpoint of an outsider rather than from that of a manager.
- Late 1950s – focus shifted to managerial decisions regarding the choice of assets and liabilities with the goal of maximizing the value of the firm.
- 1990s to date – focus on value maximization continued but two trends have become increasingly important: the globalization of business and the increased use of information technology.
Role of Finance in a Typical Business Organization

- Board of Directors
  - President
    - VP: Sales
    - VP: Finance
    - VP: Operations
      - Treasurer
      - Controller
        - Credit Manager
        - Inventory Manager
        - Capital Budgeting Director
          - Cost Accounting
          - Financial Accounting
          - Tax Department

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Scope of Financial Management

- Money and capital markets - which deals with securities markets and financial institutions;
- Investments - which focuses on the decisions made by both individual and institutional investors as they choose securities for their investment portfolios;
- Financial management - or ‘business finance’, which involves decisions within firms.
FINANCIAL MANAGEMENT DECISIONS

- **Capital budgeting**: The process of planning and managing a firm’s long term investment.

- **Capital structure**: The mixture of debt and equity maintained by the firm.

- **Working capital management**: A firms short terms asset and liabilities.
Capital budgeting (or investment appraisal) is the planning process used to determine whether a firm's long term investments such as new machinery, replacement machinery, new plants, new products, and research development projects are worth pursuing. It is budget for major capital, or investment, expenditures.
Capital Budgeting Techniques

- Net present value (NPV) - each potential project's value is estimated using a discounted cash flow (DCF) valuation, to find its NPV

- Profitability index (PI) - identifies the relationship of investment to payoff of a proposed project

- Internal rate of return (IRR) - defined as the discount rate that gives a net present value of zero. It is a commonly used measure of investment efficiency.
Capital Budgeting Techniques (cont’d)

- Modified internal rate of return - is a financial measure used to determine the attractiveness of an investment. It is generally used as part of a capital budgeting process to rank various alternative choices.

- Equivalent annuity - expresses the NPV as an annualized cash flow by dividing it by the present value of the annuity factor. It is often used when assessing only the costs of specific projects that have the same cash inflows.
Project Ranking

- The real value of capital budgeting is to rank projects. Most organizations have many projects that could potentially be financially rewarding. Once it has been determined that a particular project has exceeded its hurdle, then it should be ranked against peer projects. The highest ranking projects should be implemented until the budgeted capital has been expended.
Capital Structure

- **Capital structure** refers to the way a company finances its assets through some combination of equity, debt, or hybrid securities. A firm's capital structure is then the composition or 'structure' of its liabilities.
Capital Structure in a perfect market

- Assume a perfect capital market (no transaction or bankruptcy costs; perfect information); firms and individuals can borrow at the same interest rate; no taxes; and investment decisions aren't affected by financing decisions.
Capital structure in real world

- If capital structure is irrelevant in a perfect market, then imperfections which exist in the real world must be the cause of its relevance
Working Capital Decision

- These are decisions involving managing the relationship between a firm's short-term assets and its short-term liabilities. The goal of working capital management is to ensure that the firm is able to continue its operations and that it has sufficient cash flow to satisfy both maturing short-term debt and upcoming operational expenses.

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Working capital management

- **Cash management.** Identify the cash balance which allows for the business to meet day to day expenses, but reduces cash holding costs.

- **Inventory management.** Identify the level of inventory which allows for uninterrupted production but reduces the investment in raw materials - and minimizes reordering costs - and hence increases cash flow;
Working capital management

- Debtors management. Identify the appropriate credit policy, i.e. credit terms which will attract customers, such that any impact on cash flows and the cash conversion cycle will be offset by increased revenue and hence Return on Capital (or vice versa).
Working capital management

- **Short term financing.** Identify the appropriate source of financing, given the cash conversion cycle: the inventory is ideally financed by credit granted by the supplier; however, it may be necessary to utilize a bank loan (or overdraft), or to "convert debtors to cash" through "factoring".

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Developing a financial forecast

- Identify the requirements for your situation
- Obtain all the facts, determine assumptions within facts
- Identify missing information, relevance, problems; assess materiality
- Identify financial patterns (trends, averages, forecasts)
Developing a financial forecast

- Determine if additional research is needed; identify significant macro issues or events; identify assumptions needed for missing information
- Build the forecast
- Test forecast for sensitivity, review for reasonableness and ability to monitor
- Assess effectiveness of plan in meeting the objectives (pros/cons)
- Consider alternative solutions
Responsibility of the Finance Manager

- Efficiently manage entity resources
- Effectively mitigate risks to attain entity objectives
- Maintain a sound financial condition within the limits of available resources
- Comply with applicable policies, laws and regulations.
Financial management and internal controls

Internal Control is any process, created and implemented by management designed to give *reasonable assurance* regarding the achievement of objectives in the following three categories:

- Effective and efficient operations;
- Reliable financial information; and,
- Compliance with laws and regulations.
Operations
- Promotes efficiency and effectiveness of operations through standardized processes
- Ensures the safeguarding of assets through control activities

Financial
- Promotes integrity of data used in making business decisions
- Assists in fraud prevention and detection through the creation of an auditable trail of evidence

Compliance
- Helps maintain compliance with laws and regulations through periodic monitoring

WAIFEM
Components:

- Control Environment
- Risk Assessment
- Control Activities
- Information & Communication
- Monitoring
Financial Risk

- **What is Risk?**

  Risk is the threat that an event or action will adversely affect an entity’s ability to achieve its objectives and/or execute its strategies successfully.
Types of risk

- **Strategic risks** -- doing the wrong things.
- **Operating risks** -- doing the right things the wrong way.
- **Financial risks** -- losing financial resources or incurring unacceptable liabilities.
Types of risk

- **Informational risks** -- inaccurate or non-relevant information, unreliable systems, and inaccurate or misleading reports.

- **Physical risks** – loss of computer data, fire, earthquake, degradation of the environment, injury to people and/or things.
Risks have both quantitative and qualitative factors

We should consider quantitative factors:

- Cash (monetary) loss (i.e., loss of future cash flows)
- Cost of property, equipment, or inventory
- Cost of defending a lawsuit
Risks have both quantitative and qualitative factors.

We should also consider qualitative risk factors:

- Increased legislation
- Loss of public trust
- Injury to the unit’s and/or entity’s reputation
How can you deal with risk?

- Ignore the risk,
- Accept the risk,
- Transfer the risk (insurance), or
- Mitigate the risk.
Objective of IFRS 7

Entities should provide disclosures in their financial statements that enable users to evaluate:

- (a) the significance of financial instruments for the entity’s financial position and performance; and
- (b) the nature and extent of risks arising from financial instruments to which the entity is exposed during the period and at the end of the reporting period, and how the entity manages those risks.
IFRS 7 Disclosures

- Financial Risk
  - Credit Risk
  - Liquidity Risk
  - Market Risk
THANK YOU