Lecture Notes:

- **Sources of Finance:**
- A bank.
- A friend or a family member.
- Your own savings.
- By selling shares of your business. (Investors)
- **Financial Planning & Control:**
- Involved in analysis of the current and previous financial situation of the business.
- Prepares Pro-forma statements based on estimation.
- Remember: Estimates can go wrong, so be careful.
- **Steps in the Planning Process:**
    1. Establish aims and objectives of the business.
    2. Identify available options.
    3. Evaluate each option and make a selection.
- **Preparing the Pro-forma Financial Statement:**
- Preparing pro forma financial statements involves four major steps:
    1. Identify the factors that will affect the Pro-forma statements.
    2. Forecast the sales for the period.
        - The usual starting point is to forecast sales for the period.
        - Producing a reliable sales forecast involves understanding the competitive environment and deciding upon a particular approach to forecasting.
        - Competitive Environment:
            - General Economics Conditions
            - The Industry
            - Competitive Analysis
        - Forecasting Approaches:
            - **Subjective Approach:** This approach normally relies on the views of the sales force or sales managers.
            - **Objective Approach:** This approach relies on statistical techniques or, in the case of very large businesses, econometric models.
    3. Forecast the remaining elements of the financial statements.
        - Once the level of sales has been estimated, the items appearing in the cash budget, income statement, statement of retained earnings, and balance sheet will be forecasted.
    4. Prepare the Pro-forma financial statements.
- **Financial Ratios:**
- Financial ratios provide a quick and simple means of assessing the financial health of a business.
- A ratio simply relates one figure appearing in the financial statements to some other figure appearing there.
- The problem of scale is eliminated.
- Can be expressed in various forms.
- Ratios can be grouped into categories:
    - Profitability
    - Efficiency
    - Liquidity
    - Financial leverage
    - Investment

- Key Steps in Financial Ratio Analysis:
    1. Identify the key indicators and relationships that require examination.
    2. Calculate the ratios that are considered appropriate.
    3. Interpret and evaluate the ratios.
- Key Ratios:
    - **Gross Profit Margin:** Gross Profit / Sales
    - **Net Income Margin:** Net Income / Sales
    - **Current Ratio:** Total Current Assets / Total Current Liabilities
    - **Quick Ratio:** Total Current Assets except Inventory / Total Current Liabilities
    - **Working Capital:** Total Current Assets – Total Current Liabilities
- **The Time Value of Money, Interest Rates, Risk and Inflation:**
- The main factors affecting the value of money over time are:
- **Interest Lost:** Opportunity cost.
- **Risk:** Things may not turn out as expected.
- **Inflation:** The loss of purchasing power of money over time.
- **Investment Appraisal:**
- **Accounting Rate of Return (ARR)** is the percentage rate of return that is expected from an investment or asset compared to the initial cost of investment.
- ARR = Average Profit / Average Investment
- **Payback Period:** When do I get my money back?
- **Net Present Value (NPV):** What is the present value of future cash inflows?

Textbook Notes (Chapter 10):

- **Financing the Enterprise:**
- Finance is the function of business that involves locating, collecting, packaging and redistributing capital.
- **Financial management** is planning, organizing, leading and controlling the finding and using of capital.
- Without capital businesses cannot buy or rent spaces, machinery, supplies to continue growing or even begin.
- **Chief Financial Officer (CFO)** is the senior manager responsible for overseeing the financial management of the entire organisation.
- The CFO is one of the most influential people in the organisation whether it is a not for profit organization or a for profit business.
- Finance owes its existence to 2 simple assumptions:
    - There are people who have ideas and ambitions, plans and projects that they want to undertake but they have no capital.
    - People who have capital but have no immediate need or desire to spend it.

  Note: Those who need capital don't just include the owners of businesses and entrepreneurs. It also includes managers within businesses.
- Issues that concern finance managers:
    - An individual or a department within an organisation proposes a project.
    - The project needs to be justified.
    - An estimate needs to be made of the project's cost.
    - The project must be evaluated and prioritized against alternative projects.
    - If the capital is available and the project is consistent with the organisation's mission, it can proceed.
    - If the capital is not readily available, then sources need to be identified and approached.
    - One source of capital is investors. Another source is lenders.

- Financial managers do the following:
    - Budgeting
    - Investment appraisal
    - Capital raising
    - Investor relations
    - Financial control
- **Why Businesses Need Finance:**
- A business must spend money before it can even start to make money. It needs money to rent an office, purchase equipment and hire employees.
- Few businesses become successful overnight. Amazon, which was founded in 1994, didn't make its first annual profit until 2003. Furthermore, between 1995 and 2002, Amazon paid out roughly $3 billion more in costs than it collected in revenue. It took almost 7 years before the volume of sales allowed it to break even. Until a business attains its break-even quantity of sales, it must rely on the owner's pockets (equity) or borrowed money (liability) to survive.
- At the beginning of a business's life, banks and other lenders are reluctant to lend money. They don't want to lend money to unsuccessful businesses. Banks usually only lend when business shows the ability to grow and make profits. Therefore, most young businesses must rely solely on the owner's pockets until they break even. Only after a business has broken even will banks and other lenders consider lending money.
- Therefore, at the beginning of a business's life, the CFO and other financial managers must ensure they have raised enough owner's equity at the outset, create relationships with their suppliers that will allow them to purchase on credit and ensure that no department overspends.
- **Financial Planning - Budgeting:**
- A **budget** is a forecast estimate of the cost of the plans and projects that the organisation wants to carry out in the coming period.
- A **budget deficit** occurs when the cost of an organization's business' plans and projects exceed its inflows.
- A **budget surplus** occurs when an organisation's inflows exceed the cost of its plans and projects.
- **Financial Planning - Investment Appraisal:**
- **Investment appraisal** is the assessment of the attractiveness of competing investment opportunities.
- Businesses, in addition to worrying about the cost of this year's projects and plans, will be looking further down the road to future projects. The role of finance is to appraise and prioritize these.
- While many factors will influence the decision to make a major investment, some of the fundamental considerations will be:
    - **Size of investment:**
        - How much would the investment cost?
    - **Length of Investment:**
        - Investors are more likely to invest in a project if the returns are expected in the near future.
        - Investments with shorter payback periods are preferred as they involve fewer unanticipated changes in the business environment.
        - The greater the length of any investment, the greater the risk.
        - The **payback period** is the time in which the cash generated by a project is expected to exceed the initial outflows.

- **Return on Investment:**
    - The payback period alone is not enough to separate attractive projects from others. Long term commitments and small but steady returns is also good.
- **Risk of Return:**
    - **Risk of return** is the range of possible returns from an investment, if it doesn't perform exactly according to the forecaster's assumptions.
    - Since any investment has risk and risk has a range of possible outcomes, financial managers must make forecasts about the profit that will come from a project or investment. These forecasts are often presented using several scenarios, which show a variety of possible outcomes. This scenario analysis typically consists of:
        - Base/Expected case: Investment performs largely as expected.
        - Best/Optimistic case: One or two things go better than expected.
        - Worst/Pessimistic case: One or two things go worse than expected.
    - An investment whose return will not vary much between best and worst case has low risk.
    - An investment whose range of possibilities is large has high risk.
- **Financial Organization - Capital Raising:**
- Once the organization's projects and investments have been appraised and prioritized, financial managers will start to raise capital.
- There are different ways/methods of raising capital:
    - A sole proprietor can take on partners or incorporate.
    - A partnership can look for additional partners or incorporate.
    - A private corporation can invite its existing shareholders to buy more shares.
    - A public corporation can invite its existing shareholders to buy more shares or make new shares available to the public.
    - Any type of business can borrow money from lenders.
- Raising capital from debt or liabilities has both advantages and disadvantages. The same goes for raising capital from owner's equity. The choice of how best to raise the necessary capital will depend on the relative merits and costs of each source and type of finance.
- **Capital structure** is the combination of the debt and equity capital that a business chooses to use in order to finance its operations and growth.
- <u>Equity Financing:</u>
- For growing businesses, either the owner can invest more or look for new investors to invest in their business. New investors can bring new ideas and perspectives. However the injection of new capital dilutes the ownership of the existing owner.
- **Dilution** is a decrease in the proportion owned by existing partners or shareholders, after new investors put capital into a business.
- For example, suppose your company has 100 shares in circulation, of which you have 10. That means you own 10% of the company. Now, in order to raise more capital, your company decides to put out another 100 shares. Now, there are 200 shares in circulation but you still have 10. That means you now own 5% of the company.
- A disadvantage of equity financing is that people who start businesses tend to be independent and achievement oriented. Some entrepreneurial personalities are not comfortable with sharing decision making or explaining themselves. This may lead to irreconcilable disagreements with other investors. For example, Steve Jobs was fired from Apple for being difficult to work. However, he returned 12 years later.

- <u>Debt Financing:</u>
- Debt Finance - Advantages:
    - Owners don't need to dig into their own pockets or find new investors. This means that the business can grow without changing its ownership.
    - A borrower's only duty to a lender is to make the required loan repayments plus interest on time.
- Debt Finance - Disadvantages:
    - The loan must be repaid with interest.
    - The more a business borrows the more it has to pay in interest.
- Most businesses opt for a blend of both equity and debt financing to expand their business.
- **Financial Leading - Investor Relationships:**
- **Investor relations** is communicating the company's financial results, strategy and plans to everyone with an interest in a business' activities.
- Businesses finance a great deal of their activity on credit from suppliers. It is important that these suppliers be kept advised, informed and reassured.
- Businesses should have well-handled relationships with banks, investment dealers, shareholders and suppliers. This will allow them to be more supportive when the business needs to raise capital.
- Investors and lenders must be kept advised through meetings and updates. Financial managers should ensure that all interested parties are provided with quarterly and annual balance sheets and income statements.
- Typically, large businesses will conduct conference calls with investors immediately following the release of their quarterly financial statements. During these meetings, the CFO will highlight business' successes, calm fears, and provide an overview of the major issues that affected the company's performance in the last quarter and a preview of what can be expected in the upcoming quarter.
- Investor relations also call for formal presentations also known as roadshows when a business is attempting to sell shares to new investors. Finance managers will travel to major cities to give presentations to investment dealers, pension fund managers and other potential investors. Roadshows are meant to generate interest and excitement.
- **Financial Control:**
- The final responsibility of financial managers is financial control.
- **Financial control** is establishing a standard, measuring performance, and taking action to improve or regulate the raising and spending of capital.
- Recall that control has 3 parts:
    1. Establishing a standard.
    2. Measuring the performance against that standard.
    3. Improve/Correct performance if the performance doesn't reach the standard.
- The first stage is to establish a standard. The budget is the financial standard. It is meant to put a limit on expenditure by various departments and divisions of business and set goals for revenue generation.
- Examples:
    - The advertising budget for the next quarter is $3 million.
    - In the next fiscal year, our stores in Alberta are expected to deliver $20 million in revenue and $3 million in profit.
- The second stage of the control process is to measure the actual performance of the activity. The quarterly financial statements are the tools of measurement. Finance managers can look at these statements and compare the performance against the budget.

- Examples:
  - The operating expenses were 10% higher than we forecasted, due to overspending on advertising.
  - The income statement for the first half of the year shows revenues of $13 million in Alberta.
- The final stage is for managers to take action and to improve or correct performance and to bring it into line with standards.
- Examples:
  - Cancelling the TV advertisements will save $600, 000 from the market budget.
  - Our sales people in Alberta are working hard. Revenue for the first six months are 30% above forecast. We should thank them by giving them a bonus.
- The purpose of the control function is to get people and resources to perform in a manner to achieve the organization's goals.
- The role of financial managers is to plan and organise capital.
- Effective financial management will ensure that the business has capital to carry out a plan that will contribute to positive future growth of revenues, profits and return on investments.

Textbook Definitions (Chapter 10):

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- **Capital structure:** The combination of the debt and equity capital that a business chooses to use in order to finance its operations and growth.
- **Chief Financial Officer (CFO):** The senior manager responsible for overseeing the financial management of the entire organisation.
- **Dilution:** A decrease in the proportion owned by existing partners or shareholders, after new investors put capital into a business.
- **Financial control:** Establishing a standard, measuring performance, and taking action to improve or regulate the raising and spending of capital.
- **Financial management:** Planning, organizing, leading and controlling the finding and using of capital.
- **Investment appraisal:** The assessment of the attractiveness of competing investment opportunities.
- **Investor relations:** Communicating the company's financial results, strategy and plans to everyone with an interest in a business' activities.
- **Payback period:** The time in which the cash generated by a project is expected to exceed the initial outflows.
- **Risk of return:** The range of possible returns from an investment, if it doesn't perform exactly according to the forecaster's assumptions.