Chapter 18

Financial Management

Business in Action 8e

Bovée/Thill

Learning Objectives

1. Identify three fundamental concepts that affect financial decisions, and identify the primary responsibilities of a financial manager.
2. Describe the budgeting process, three major budgeting challenges, and the four major types of budgets.
3. Compare the advantages and disadvantages of debt and equity financing, and explain the two major considerations in choosing from financing alternatives.

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Learning Objectives (cont.)

4. Identify the major categories of short-term debt financing.
5. Identify the major categories of long-term debt financing.
6. Describe the two options for equity financing, and explain how companies prepare an initial public offering.

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The Role of Financial Management

- **Financial management**
  - Planning for a firm's money needs and managing the allocation and spending of funds
- **Risk/return trade-off**
  - The balance of potential risks against potential rewards

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Exhibit 18.1 Financial Management: Three Fundamental Concepts

1. Balancing short-term and long-term demands
- Must have ready cash to pay salaries, bills, and taxes
- Need a financial cushion to ride out rough times
- May need money for acquisitions or other extraordinary expenses
- Must make strategic long-term investments

2. Balancing potential risks and potential rewards
- Every decision involves a risk/reward trade-off
- Higher risks may yield higher rewards
- The safest choices aren't always the best choices

3. Balancing leverage and flexibility
- Can use debt strategically and sometimes out of necessity
- Debt can be a tool, but it can also be a trap
- Highly leveraged companies have far less ability to maneuver and are more vulnerable to setbacks

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Developing a Financial Plan

- **Financial plan**
  - A document that outlines the funds needed for a certain period of time, along with the sources and intended uses of those funds
  - Strategic plan, company's financial statements, external financial environment

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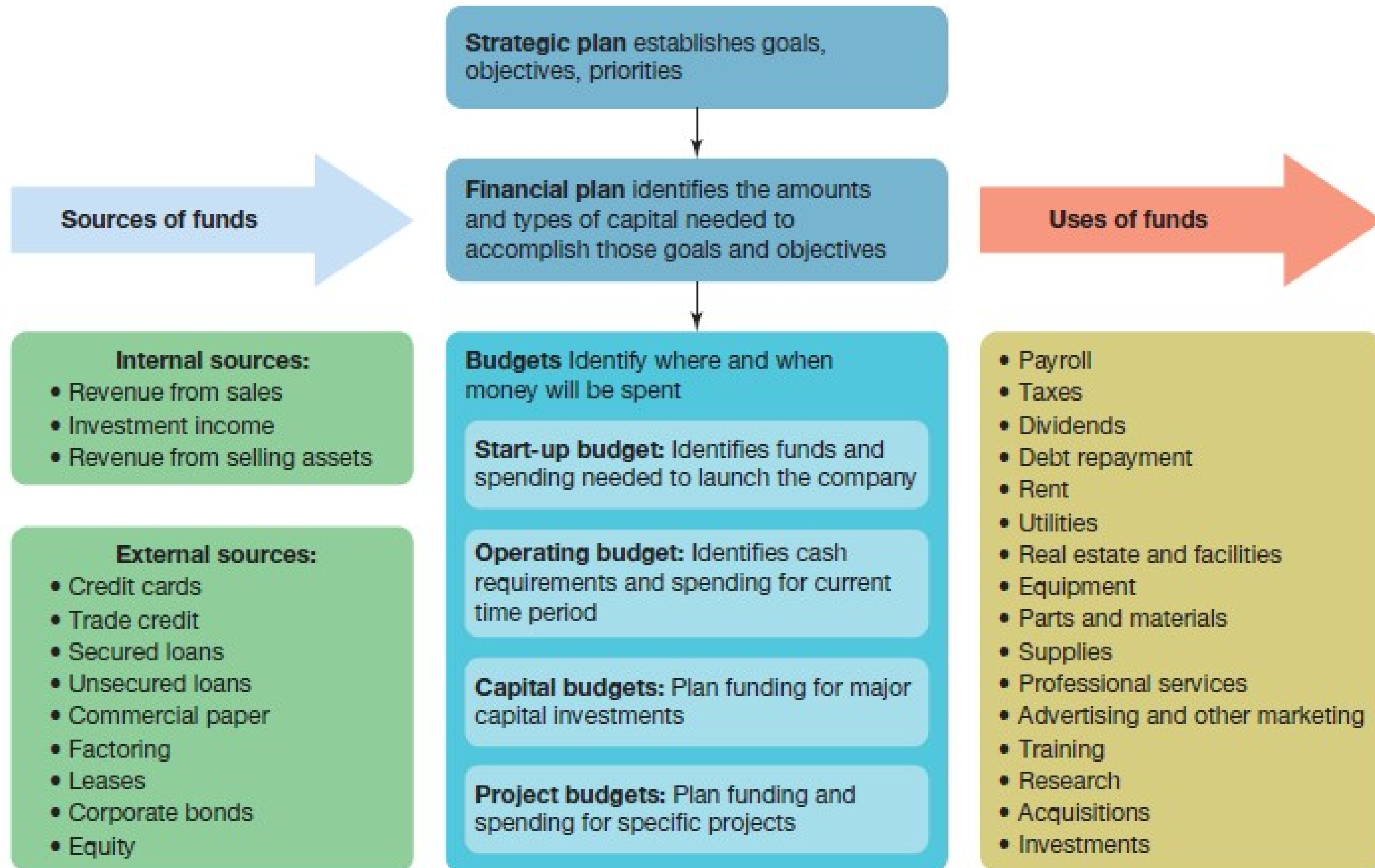
Exhibit 18.2 Finding and Allocating Funds



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Managing Accounts Receivable and Accounts Payable

- **Accounts receivable**
  - Amounts that are currently owed to a firm
- **Accounts payable**
  - Amounts that a firm currently owes to other parties

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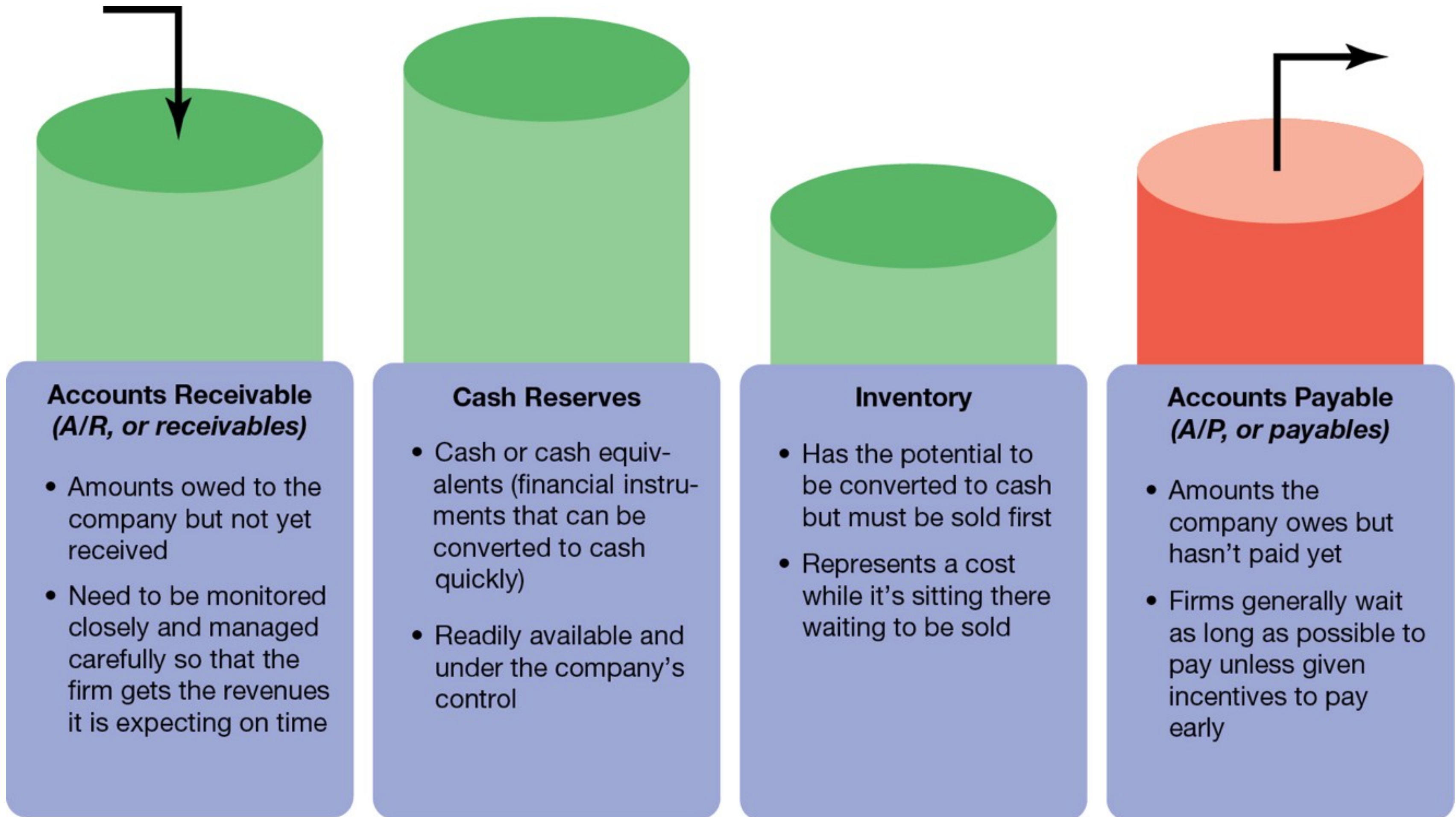
Exhibit 18.3 Monitoring the Working Capital Accounts



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The Budgeting Process

- **Budget**
  - A planning and control tool that reflects expected revenues, operating expenses, and cash receipts and outlays
- **Financial control**
  - The process of analyzing and adjusting the basic financial plan to correct for deviations from forecasted events

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Exhibit 18.4 Budgeting Challenges

1. Every company has a limited amount of money to spend.
- Projects and departments are often in competition for resources.
- Managers need to make tough choices, occasionally taking money from one group and giving it to another.

2. Revenues and costs are often difficult to predict.
- Sales forecasts are never certain, particularly for new products or for sales into new markets.
- Fixed costs are easy to predict, but variable costs can be hard to predict, particularly more than a few months out.

3. It's not always clear how much should be spent.
- With some expenses, such as advertising, managers aren't always sure how much is enough.
- Uncertainty leads to budgeting based on past expenditures, which might be out of line with current strategic needs.

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The Budgeting Process (cont.)

- **Hedging**
  - Protecting against cost increases with contracts that allow a company to buy supplies in the future at designated prices

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The Budgeting Process (cont.)

- **Zero-based budgeting**
  - A budgeting approach in which each year starts from zero and must justify every item in the budget, rather than simply adjusting the previous year's budget amounts

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Types of Budgets

- **Start-up budget**
  - A budget that identifies the money that a new company will need to spend to launch operations
- **Operating budget**
  - A budget that identifies all sources of revenue and coordinates the spending of those funds throughout the coming year
  - Also known as the *master budget*

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Types of Budgets (cont.)

- **Capital budget**
  - A budget that outlines expenditures for real estate, new facilities, major equipment, and other capital investments
- **Capital investments**
  - Money paid to acquire something of permanent value in a business

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Types of Budgets (cont.)

- **Project budget**
  - A budget that identifies the costs needed to accomplish a particular project

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Financing Alternatives: Factors to Consider

- **Debt financing**
  - Arranging funding by borrowing money
- **Equity financing**
  - Arranging funding by selling ownership shares in the company, publicly or privately

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Exhibit 18.5 Debt Versus Equity Financing

Characteristic	Debt Financing	Equity Financing
Maturity	**Specific:** In most cases, specifies a date by which debt must be repaid.	**N/A:** Equity funding does not need to be repaid.
Claim on income	**Nondiscretionary, usually a recurring cost and usually fixed:** Debt obligations must be repaid, regardless of whether the company is profitable; payments can be regular (e.g., monthly), balloon (repaid all at once), or a combination.	**Discretionary cost:** At management's discretion and if company is profitable, shareholders may receive dividends after creditors have been paid; however, company is not required to pay dividends.
Claim on assets	**Priority:** Lenders have prior claims on assets.	**Residual:** Shareholders have claims only after the firm satisfies claims of lenders.
Influence over management	**Usually little:** Lenders usually have no influence over management unless debit vehicles come with conditions or management fails to make payments on time.	**Varies:** As owners of the company, shareholders can vote on some aspects of corporate operations, although in practice only large shareholders have much influence. Private equity holders (such as venture capitalists) can have considerable influence.
Tax consequences	**Deductible:** Debt payments reduce taxable income, lowering tax obligations.	**Not deductible:** Dividend payments are not tax deductible.
Employee benefit potential	**N/A:** Does not create any opportunities for compensation alternatives such as stock options.	**Stock options:** Issuing company shares creates the opportunity to use stock options as a motivation or retention tool.

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Length of Term

- **Short-term financing**
  - Financing used to cover current expenses (generally repaid within a year)
- **Long-term financing**
  - Financing used to cover long-term expenses such as assets (generally repaid over a period of more than one year)

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Interest Rates

- **Prime interest rate**
  - The lowest rate of interest that banks charge for short-term loans to their most creditworthy customers

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Opportunity Cost

- **Leverage**
  - The technique of increasing the rate of return on an investment by financing it with borrowed funds
- **Capital structure**
  - A firm's mix of debt and equity financing

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Exhibit 18.6 Financial Leverage

No leverage; 12% return			5x leverage; 12% return	
Funds	$10,000		Funds	$10,000
Debt	$0		Debt	$50,000
Total to invest	$10,000		Total to invest	$60,000
Annual return (12%)	$1,200		Annual return (12%)	$7,200
Cost of debt	$0		Cost of debt (6%)	($3,000)
Profit (loss)	$1,200		Profit (loss)	$4,200
No leverage; –12% return			**5x leverage; –12% return**	
Funds	$10,000		Funds	$10,000
Debt	$0		Debt	$50,000
Total to invest	$10,000		Total to invest	$60,000
Annual return (–12%)	($1,200)		Annual return (–12%)	($7,200)
Cost of debt	$0		Cost of debt (6%)	($3,000)
Profit (loss)	($1,200)		Profit (loss)	($10,200)

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Financing Alternatives: Short-Term Debt

- **Trade credit**
  - Credit obtained by a purchaser directly from a supplier
- **Secured loans**
  - Loans backed up with assets that the lender can claim in case of default, such as a piece of property

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Financing Alternatives: Short-Term Debt (cont.)

- **Unsecured loans**
  - Loans that require a good credit rating but no collateral
- **Compensating balance**
  - The portion of an unsecured loan that is kept on deposit at a lending institution to protect the lender and increase the lender's return

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Financing Alternatives: Short-Term Debt (cont.)

- **Line of credit**
  - An arrangement in which a financial institution makes money available for use at any time after the loan has been approved
- **Commercial paper**
  - Short-term *promissory notes*, or contractual agreements, to repay a borrowed amount by a specified time with a specified interest rate

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Exhibit 18.7 Sources of Long-Term Debt Financing

Source	Funding Mechanism	Length of Term	Advantages	Disadvantages and Limitations
Long-term loans	Bank or other lender provides cash; borrower agrees to repay according to specific terms	From 1 to 25 years	Can provide substantial sums of money without diluting ownership through sale of equity; allows company to make major purchases of inventory, equipment, and other vital assets	Not all companies can qualify for loans and acceptable terms; payments tie up part of cash flow for the duration of the loan; purchases made via loans require substantial down payments
Leases	Company earns the right to use an asset in exchange for regular payments; arrangement can be directly between lessor and lessee or can involve a third party such as a bank	Typically several years for equipment and vehicles; longer for real estate	Usually require lower down payments than loans; can provide access to essential assets for companies that don't qualify for loans; let company avoid buying assets that are likely to decline in value or become obsolete; often free company from maintenance and other recurring costs	Can restrict how assets can be used; company doesn't gain any equity in return for lease payments, except in the case of lease-to-own arrangements; can be more expensive than borrowing to buy
Corporate bonds	Company sells bonds to investors, with the promise to pay interest and repay the principle according to a set schedule	Typically from 10 to 30 years	Can generate more cash with longer repayment terms than are possible with loans	Available only to large companies with strong credit ratings

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Long-Term Loans

- Character
- Capacity
- Capital
- Conditions
- Collateral

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Leases

- **Lease**
  - An agreement to use an asset in exchange for regular payment
  - Similar to renting

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Corporate Bonds

- **Bonds**
  - A method of funding in which the issuer borrows from an investor and provides a written promise to make regular interest payments and repay the borrowed amount in the future

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Corporate Bonds (cont.)

- **Secured bonds**
  - Bonds backed by specific assets that will be given to bondholders if the borrowed amount is not repaid
- **Debentures**
  - Corporate bonds backed only by the reputation of the issuer

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Corporate Bonds (cont.)

- **Convertible bonds**
  - Corporate bonds that can be exchanged at the owner's discretion into common stock of the issuing company

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Private Equity

- **Private equity**
  - Ownership assets that aren't publicly traded
  - Includes venture capital

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Public Stock Offerings

- Preparing the IPO
- Registering the IPO
- Selling the IPO

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Public Stock Offerings (cont.)

- **Underwriter**
  - A specialized type of bank that buys the shares from the company preparing an IPO and sells them to investors
- **Prospectus**
  - An SEC-required document that discloses required information about the company, its finances, and its plans for using the money it hopes to raise

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Applying What You've Learned

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Applying What You've Learned (cont.)

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