

THE ROLE OF FINANCIAL PLANNING



Multiple choice

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|------|-------|
| 1. C | 6. D |
| 2. C | 7. A |
| 3. B | 8. B |
| 4. B | 9. C |
| 5. A | 10. D |

Short answer questions

Question 1

- (a) **Liquidity refers to the ability of the business to meet its short term obligations (debt)**
- (b) **By having insufficient stock at the moment, Mary is unable to pay her bills unless she makes an extra effort to sell some stock or make a call on her creditors. This inability to pay today means she has a minor liquidity problem.**
- (c) **Although Mary does not have the cash to pay immediately, she does have a large stock of current assets that could be used to pay the bills. Mary could have a fire sale or her stock to raise cash, or she could call in the debts from her creditors (or use other methods such as factoring to gain immediate cash) which would also give her the necessary cash to pay her bills, meaning she does not have a liquidity problem.**

Question 2 (

- (a) **Financial will help AC Enterprises both budget for the new machines as well as monitor whether they are achieving the promised cost reductions. Financial report will identify if the machines are causing a liquidity problem and if the regular repayments are unsustainable.**
- (b) **(i) Liquidity: In the short term liquidity will be constrained due to set up costs and the regular repayments, however, in the long term the cost reductions and increased sales will increase cash and thus liquidity.**
(ii) Profitability: As the new machines will increase production this should lead to increased revenues which combined with cost reductions should increase the long term profit of the business.
(iii) Efficiency: The machine can lower costs at the same time as increasing output. If the cost reductions are less than the value of the extra output produce financial efficiency has been increased.

(iv) **Growth:**The increase in production from the machine will allow the company to increase sales and thus achieve increased growth.

Question 3

- (a) **Liquidity and Growth**
- (b) **By maintaining records a business can satisfy the financial needs of all internal and external stakeholders. Apart from requiring financial records by law, financial records allow a business to maintain and predict their financial position over time, to maximise the efficiency with which their financial objectives are met. By using records to produce financial reports management can observe and predict the business's financial cycle in action.**
- (c) **The financial management at Moydale Ltd was less than adequate. It appears that Moydale's management had a strategy to increase the business growth levels but they failed to find a balance between the financial objective of growth and all other objectives. By only pursuing growth the business became over liquidity constrained and as a result its operations failed and its profit and return on capital suffered. This demise was obviously fostered by a lack of awareness on the part of management that record systems allow a business to produce financial reports which would have warned them of their imminent demise.**

Question 4

- (a) **Growth and profitability**
- (b) **Financial planning is important as it allows a business to maximise the efficiency with which funds are raised, used and monitored. For Calx, financial planning would have allowed them to raise the necessary funds for their 2002 purchase. Additionally, financial planning is important to ensure the business is not merely sacrificing other financial objectives for growth, when it must instead try to achieve all financial objectives simultaneously.**
- (c) **Budgeting will allow Calx to maintain an appropriate level of cash to pay employee wages and meet debt commitments. This is achieved with a cash flow budget which outlines the business's cash inflows and outflows over the future period.**

Additionally, budgeting will allow Calx to monitor the profits and cash flows associated with their new business. By budgeting, Calx can monitor the financial performance of a previously unknown business and ensure it is meeting targets by then comparing these budgets to actual performance.

- (d) **Although Calx has achieved the financial objectives of profitability and growth, some may believe it has sacrificed the goal of liquidity to achieve these. However, Calx most likely has a range of current assets that could still be used to meet its current liabilities. Thus it is not in financial jeopardy.**

Calx could implement two procedures to fix its short term liquidity problem. Firstly, Calx could sell its debts (factoring) to increase its immediate cash balance. Secondly, Calx should implement weekly account meetings so that management can actual financial performance and compare it to budgeted performance, allowing it to simultaneously achieve all of its financial objectives.

Question 5

- (a) **Profitability relates to the earnings potential of a business and is the difference between a business's revenues and its expenses. If a business's revenues exceed its expenses, then a business is making a profit. If a business's expenses exceed its revenues, it will be making a loss instead of a profit.**

- (b) **Cash is the most liquid asset and it thus generates very low returns. Cash could instead be invested in less liquid investments that generate higher returns, increasing a business's return on capital.**

- (c) **As noted in (b) above, the liquidity of an asset will often be inversely related to the returns it can generate. Although management may then think that property is a good investment as it traditionally generates high returns, this ignores the other financial objectives. As property is a very illiquid asset, the business will be unable to use these funds to meet short term debt obligations. As the business's revenue streams are so variable this is a dangerous move. Additionally, as it pays all its suppliers in cash it will often need high level of cash in the short term – which is in conflict with the move to property. Therefore, it is not efficient financial management.**