4 The Role of Financial Planning

Matching

Definitions	**Terms**
The ease with which an asset can be converted into cash	Liquidity
Things owned by a business which can be converted into cash with twelve months	Current assets
Debts of the business which must be repaid within twelve months	Current liabilities
Funds which are provided by the owners of a business	Equity finance
Funds which are borrowed by the business	Debt finance
Funds which the business accumulates from profits which are not paid to the owners	Retained profits
The management and use of assets by a business which achieves the greatest return for the least amount of assets	Efficiency
A systematic recurring plan which starts with present financial position, develops budgets and reports, plans financial controls and minimises risks and losses	Planning cycle
The inflow of funds from cash and credit sales of a business	Revenue
The financial benchmarks which management hopes to achieve	Objectives of financial management

True or False

1. True
2. False
3. True
4. True
5. False
6. True
7. False
8. True
9. True
10. True

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Multiple Choice

1	C	Objectives of financial management
2	A	Objectives of financial management
3	A	Objectives of financial management
4	D	Objectives of financial management
5	B	The planning cycle
6	D	The planning cycle
7	B	The planning cycle
8	C	Objectives of financial management
9	D	Objectives of financial management
10	C	Objectives of financial management

Short Answer Questions

Question 1

(a) Working Capital = current assets divided by current liabilities
= 25000/20000
= 1.25:1

(b) A bank overdraft is a type of short term debt finance and allows a business to overdraw its cheque account. That is it can write out cheques for more than what is in the account up to an amount agreed to by the bank. If the business overdraws its account, it pays interest on the amount it has overdrawn or borrowed. The overdraft would be handy if there were cash flow problems. Flotara has a large amount of accounts receivable outstanding.

(c) The accounts payable is also large at $16 000. Accounts Payable refers to short term debt so that this would have to be paid off within 12 months, or even sooner. Even with cash ($2000) and inventory there is not enough to cover the accounts payable. Most businesses or creditors that allow credit will have a repayment date such as seven days or 28 days. Flotara needs to have controls to make sure that these accounts are paid within the period allowed to avoid paying interest on overdue amounts.

(d) Flotara should attempt to improve its liquidity and working capital, especially in terms of cash. It needs to convert more accounts receivable into cash. By doing this, Flotara will be moving towards greater efficiency by getting greater return by using a smaller level of assets.

As Flotara moves towards improving its cash position and efficiency it should be aiming to improve its growth rate both of total assets, revenue and dividends. As Flotara moves towards improving the growth rate of revenue it needs to look at the costs of achieving that revenue and try to reduce those costs as far as possible. By doing this, Flotara will improve its profitability.

Owners Equity is $25 000. As the business grows and profitability increases, net profit should grow. If annual net profit was in the order of $10 000, this would indicate an annual return on equity of 40% which would be very good.

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Question 2

(a) address present financial position---------- determine financial elements of the plan---------- develop budget---------- monitor cash flows------------ maintain record systems--------- implement financial controls

(b) It is important for a business to have a workable financial plan that will contribute to the business achieving its financial goals. The best starting point for any financial plan is to begin with where the business is now – the present financial position. Next, the financial elements or objectives need to be determined, such as a need to increase sales as part of improving return on equity. Budgets will give these objectives meaning and will show how they are to be achieved. After the budgets are put into place it is a logical step to monitor cash inflows and outflows to assess how well the budgets are working. A part of this process would be to maintain record systems so that it is possible to communicate financial information of the business. Finally, implementing financial controls as a result of information given by the financial reports should occur. These controls could relate to inventory, accounts receivable and payable and would be flagged by ratios as a result of the financial records.

(c) Addressing the present financial position refers to collecting information or preparing a "snapshot" of where the business is now, financially. This could refer to the liquidity position of the business, what is the gearing position of the business, is the business efficient or profitable, or has there been growth since the last financial assessment of the business.

Determining the financial elements of the plan is an important element of the plan. If the business needs to produce more output to meet a growing demand in the market it may need to borrow more funds to purchase more equipment to expand production. This could involve increasing the gearing levels of the business.

The next step after determining the financial elements is preparing budgets. These show how the objectives will be achieved. If the business is to produce more output by borrowing money to buy new equipment, then a budget needs to be prepared to show how the funds that have been borrowed will be repaid. The budget would show how much increase in production would be contributed by the new machinery and what would be the expected revenue raised from the sale of this production and how much would be required to service the borrowing.

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