

Topic Review

Topic 2: Financial Planning and Management

Multiple Choice

- 1 A The role of financial planning
- 2 B Financial markets relevant to business financial needs
- 3 D Financial markets relevant to business financial needs
- 4 B Financial markets relevant to business financial needs
- 5 A Management of funds
- 6 A Effective working capital management
- 7 B Management of funds
- 8 C Management of funds
- 9 C Using financial information
- 10 B Using financial information
- 11 A Using financial information
- 12 B Using financial information
- 13 D Effective working capital management
- 14 B Effective working capital management
- 15 C Effective financial planning
- 16 C Ethical and legal aspects
- 17 A Ethical and legal aspects

Short Answer Questions

Question 1

- (a) Banks are major participants in Australian financial markets. Banks acquire funds by borrowing from depositors. They lend these funds to borrowers against some type of security.

Superannuation funds are another type of financial intermediary which are becoming a major source of business funding. People who are trying to provide for their retirement purchase pensions from superannuation funds by paying money to the funds on a regular basis. The superannuation funds invest this money by buying shares, property, making secured deposits with banks and purchasing other secure financial instruments such as debentures.

Merchant banks appeared in Australia in the 1950s. These banks are more investment banks, trading in money, securities and futures markets. They specialise in organising long-term finance for business clients. Merchant banks also advise on mergers and takeovers. Some merchant banks guarantee short and medium-term business debt.

- (b) Internal sources of funds come from within the business and are usually made up of equity. These funds include the owners' equity of funds provided for the business by the owners, profits that are not distributed (as dividends to the owners) or retained profits or funds from the sale of assets.

External funds come from outside the business and include funds from selling shares to new owners, government grants, inviting a new partner to enter the business or form venture capital where superannuation funds or other investors provide equity or debt funding.

- (c) One problem with raising finance from equity sources is that if it is done through the sale of shares, it dilutes the ownership of the business. Taking retained profits also reduces the dividends paid to the owners. The advantages of equity finance are that the business has not incurred any new debt by borrowing and in that sense will not have increased liabilities.

Debt finance involves the business borrowing money.

Question 2

- (a) Net profit and return on equity are profitability ratios. Expense ratio and accounts receivable turnover ratio are efficiency ratios.
- (b) (i) The net profit ratio has improved between 2006 and 2007. This could mean that the business has improved its net profit while sales have remained the same or net profit could have remained the same while sales have fallen. When return on equity is examined, it has decreased from 2006 to 2007. If we assume that net profit has remained the same in 2007 compared to 2006 for both ratios, then owners' equity must have risen in 2007.
- (ii) The expense ratio has increased which could indicate that expenses have increased while sales have remained the same. At the same time accounts receivable indicates that either credit sales have remained the same or the amount of accounts receivable has decreased. This means that it is now taking about 6 fewer days for accounts receivable to turn over (20 days compared to the usual 30 days allowed).
- (c) One limitation of financial reports arises from the valuation of assets. With the ratios expressed in the stimulus, most of these could have been affected by the treatment of accounts receivable by the business. If the business has written off some amount of accounts receivable as bad debts, the amount of accounts receivable will be reduced which will improve the accounts receivable turnover. On the other hand as bad debts increase, net profit will fall, because bad debts are an expense which will reduce net profit.

Question 3

- (a) Working Capital is the difference between current assets and current liabilities and indicates whether the business has the ability to pay off what it owes to its creditors in the short term. If there are substantially more current assets (especially cash) compared to current liabilities then the business will have the ability to cover its short term debt.
- (b) (i) Factoring could be a good short term solution to improving Boracay's working capital. Part of Boracay's problem is a shortage of cash and with debtors slow to pay accounts, a quick solution would be for Boracay to sell its accounts receivable to a finance company. One disadvantage of this would be the fact that the debts would be sold at a discount so Boracay would not get the full value of what it is owed. On the other hand it would be paid cash and this would improve working capital. Also note, accounts receivable are low so factoring may not be effective for such small amounts of accounts receivable

- (ii) Sale and lease back would also help to improve working capital. Here, the business would sell some fixed assets to a business such as a finance company which would then lease the asset back to the business. Boracay would benefit by getting the market value of the asset it sold and this would improve working capital. It would, however need to lease back the asset which would reduce some of the gain from the sale. One advantage would be a tax benefit from leasing the asset
- (c) (i) This depends on how well debtors respond to shorter repayment periods. Boracay could reduce the terms to seven days. If this reduction in terms worked then the strategy would be good for cash flow. Boracay needs to be careful that this move does not increase bad debt.
- (ii) If Boracay offered debtors a discount for early payment this could have the result of improving cash flow. However, Boracay needs to be prepared to forego some of the funds it might have earned by offering the discount. Debtors would also balance the benefit of early payment against paying just in time. It may be worth it not to settle the account until it was due. If this happened this strategy would not improve Boracay's cash flow.