



# “ From Learning to Earning: Boost Skills, Bridge Gap



# Entrepreneurship Training Package

## **Module 5: Financial Management**

EUROTraining Educational Organization (PP2)





# Module learning objectives

After completing this module you will be able to:

- Apply the basic concepts of financial management and financial decision-making
- Assess financial statements in order to identify organisational strengths and weaknesses
- Analyse and evaluate the financial viability of selected projects
- Understand the principles of capital budgeting



# Entrepreneurship Training Package

## **Introduction to financial management**

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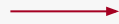


# → Finance



Finance is defined by Webster's dictionary as "the system that includes the circulation of money, the granting of credit, the making of investments and the provision of banking facilities".





# Areas of Finance



- Financial management: focuses on decisions relating to how much and what types of assets to acquire, how to raise the capital needed to purchase assets and how to run the business so as to maximise its value.



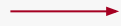


# Areas of Finance



- Capital markets: relate to the markets where interest rates, along with stock and bond prices are determined. It also includes financial institutions that supply capitals to the businesses (banks, investment banks, stockbrokers, mutual funds, insurance companies, government organisations, etc.)





# Areas of Finance



- Investments: relate to decisions concerning stocks and bonds and include a number of activities, such as security analysis, portfolio theory, market analysis and so on).





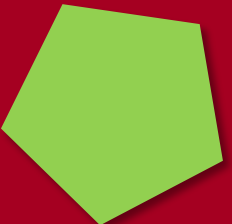


# Objectives of financial management



- Maximizing profits.
- Tracking liquidity and cash flow.
- Ensuring compliance.
- Developing financial scenarios.
- Manage relationships.

Ultimately, it's about applying effective management principles to the company's financial structure.



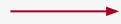


# Scope of financial management



1. **Planning.** The financial manager projects how much money the company will need in order to maintain positive cash flow, allocate funds to grow or add new products or services and cope with unexpected events, and shares that information with business colleagues. Planning may be broken down into categories including capital expenses, workforce and indirect and operational expenses.





# Scope of financial management



2. **Budgeting.** The financial manager allocates the company's available funds to meet costs, such as mortgages or rents, salaries, raw materials, employee expenses and other obligations. Ideally there will be some left to put aside for emergencies and to fund new business opportunities.





# Scope of financial management



**3. Managing and assessing risk.** Line-of-business executives look to their financial managers to assess and provide compensating controls for a variety of risks, including:

- Market risk
- Credit risk
- Liquidity risk
- Operational risk.



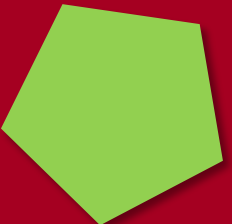


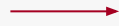
# Scope of financial management



- 4. Procedures.** The financial manager sets procedures regarding how the finance team will process and distribute financial data, like invoices, payments and reports, with security and accuracy. These written procedures also outline who is responsible for making financial decisions at the company — and who signs off on those decisions.

Companies don't need to start from scratch; there are policy and procedure templates available for a variety of organisation types.





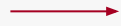
# The goal of the Financial Manager



- Making investment decisions (capital budgeting decisions).
- Making decisions on how to finance these investments (capital structure decisions).
- Making decisions on how best to manage the company's day-to-day operations (working capital management).



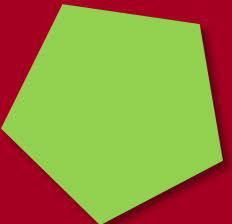


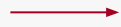


# The five basic principles



1. Money has a time value, which means that 1 euro today, has more value than a euro received in the future.





# The five basic principles



2. There is a risk-return tradeoff, which means that an investor will not take on additional risk, unless they expect to be compensated with additional return





# The five basic principles



3. Cash flows are the source of value. Profit is an accounting concept designed to measure a business's performance over an interval of time. Cash flow is the amount of cash that can actually be taken out of the business over this same interval.





# The five basic principles



4. Market prices reflect information. Investors respond to new information by buying and selling their investments. The speed with which investors act and the way that prices respond to the information determine the efficiency of the market





# The five basic principles



5. Individuals respond to incentives. Incentives motivate, and the actions of managers are often motivated by self-interest, which may result in managers not acting in the best interests of the firm's owners. When this happens the firm's owners will lose value



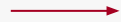
# Entrepreneurship Training Package

## Capital markets

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# What are capital markets



Capital markets are where savings and investments are channeled between suppliers—people or institutions with capital to lend or invest—and those in need. Suppliers typically include banks and investors while those who seek capital are businesses, governments, and individuals.





# What are capital markets



Capital markets are composed of primary and secondary markets. The most common capital markets are the stock market and the bond market.

Capital markets seek to improve transactional efficiencies. These markets bring suppliers together with those seeking capital and provide a place where they can exchange securities.

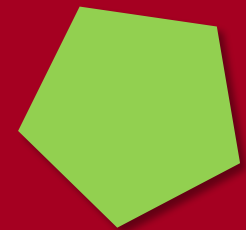




# Understanding Capital Markets



Capital market is a broad term used to describe the in-person and digital spaces in which various entities trade different types of financial instruments. These venues may include the stock market, the bond market, and the currency and foreign exchange markets. Most markets are concentrated in major financial centers such as New York, London, Singapore, and Hong Kong.





# Understanding Capital Markets



These markets are divided into two different categories: primary markets—where new equity stock and bond issues are sold to investors—and secondary markets, which trade existing securities. Capital markets are a crucial part of a functioning modern economy because they move money from the people who have it to those who need it for productive use.





# Primary Market



When a company publicly sells new stocks or bonds for the first time—such as in an initial public offering (IPO)—it does so in the primary capital market. This market is sometimes called the new issues market. When investors purchase securities on the primary capital market, the company that offers the securities hires an underwriting firm to review it and create a prospectus outlining the price and other details of the securities to be issued. All issues on the primary market are subject to strict regulation.

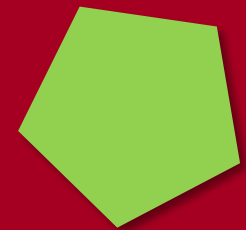




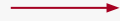
# Primary Market



Small investors are often unable to buy securities on the primary market because the company and its investment bankers want to sell all of the available securities in a short period of time to meet the required volume, and they must focus on marketing the sale to large investors who can buy more securities at once.





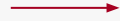


# Secondary Market



The secondary market, on the other hand, includes venues overseen by a regulatory body where these previously issued securities are traded between investors. Issuing companies do not have a part in the secondary market.

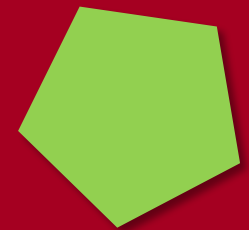




# Secondary Market



The secondary market has two different categories: the auction and the dealer markets. The auction market is home to the open outcry system where buyers and sellers congregate in one location and announce the prices at which they are willing to buy and sell their securities. In dealer markets, though, people trade through electronic networks. Most small investors trade through dealer markets.



# Entrepreneurship Training Package

## Financial Statements

EUROTraining Educational Organization (PP2)





# Basic Financial Statements



The accounting and financial regulatory authorities mandate that firms provide the following four types of financial statements:

1. **Income statement**—includes the revenues the firm has earned, the expenses it has incurred to earn those revenues, and the profit it has earned over a specific period of time, usually a quarter of a year or a full year.





# Basic Financial Statements



- 2. Balance sheet**—contains information as of the date of its preparation about the firm's assets (everything of value the company owns), liabilities (the company's debts), and stockholders' equity (the money invested by the company owners). As such, the balance sheet is a snapshot of the firm's assets, liabilities, and stockholders' equity for a particular date.



# Basic Financial Statements



3. **Cash flow statement**—reports cash received and cash spent by the firm over a specific period of time, usually a quarter of a year or a full year.



# Basic Financial Statements



4. **Statement of shareholders' equity**—provides a detailed account of activities in the firm's common and preferred stock accounts and its retained earnings account and of changes to shareholders' equity that do not appear in the income statement.



# The added value of financial statements



Analysing a firm's financial statements can help managers carry out:

1. **Financial statement analysis.** The basic objective of financial statement analysis is to assess the financial condition of the firm being analysed. In a sense, the analyst performs a financial analysis so they can see the firm's financial performance the same way an outside investor would see it.






# The added value of financial statements



Analysing a firm's financial statements can help managers carry out:

2. **Financial control.** Managers use financial statements to monitor and control the firm's operations. The performance of the firm is reported using accounting measures that compare the prices of the firm's products and services with the estimated costs of providing them to buyers. Moreover, the board of directors uses these performance measures to determine executives' bonuses. In addition, the company's creditors use performance measures based on the firm's financial statements to determine whether or not to extend loans to the company.





# The added value of financial statements



Analysing a firm's financial statements can help managers carry out:

3. **Financial forecasting and planning.** Financial statements provide a universally understood format for describing a firm's operations. Consequently, financial planning models are typically built using the financial statements as a prototype.






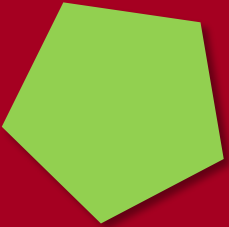
# The income statement



An income statement, also called a profit and loss statement, measures the amount of profits generated by a firm over a given time period (usually a year or a quarter). In its most basic form, the income statement can be expressed as follows:

$$\text{Revenues (or Sales)} - \text{Expenses} = \text{Profits}$$

Revenues represent the sales for the period. Profits are the difference between the firm's revenues and the expenses it incurred in order to generate those revenues for the period.






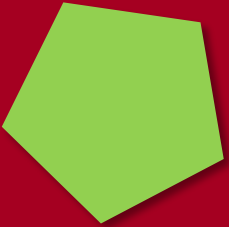
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# Income statement example

Sales		\$2,700.00	
Cost of goods sold		(2,025.00)	
Gross profit		\$ 675.00	
Operating expenses:			
Selling expense	\$(90.00)		
General and administrative expense	(67.50)		
Depreciation and amortization expense	(135.00)		
Total operating expenses		(292.50)	
Net operating income (EBIT, or earnings before interest and taxes)		\$ 382.50	Income from operating activities
Interest expense		(67.50)	Cost of debt financing
Earnings before taxes		\$ 315.00	
Income taxes		(110.25)	Cost of corporate income taxes
Net income		<u>\$ 204.75</u>	Income resulting from operating and financing activities
Additional information:			
Dividends paid to stockholders during 2016		\$ 45.00	
Number of common shares outstanding		90.00	
Earnings per share (EPS)		\$ 2.28	
Dividends per share		\$ 0.50	

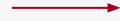


# The balance sheet



The income statement reports the cumulative results from operating the business over a period of time, such as one year. By contrast, the balance sheet is a snapshot of the firm's financial position on a specific date. In its simplest form, the balance sheet is defined by the following equation:

$$\text{Total Assets} = \text{Total Liabilities} + \text{Total Shareholder's Equity}$$

# The balance sheet



Total liabilities represent the total amount of money the firm owes its creditors (including the firm's banks and suppliers). Total shareholders' equity refers to the difference in the value of the firm's total assets and the firm's total liabilities recorded in the firm's balance sheet.





# The balance sheet



As such, total shareholders' equity refers to the book value of their investment in the firm, which includes both the money they invested in the firm to purchase its shares and the accumulation of past earnings from the firm's operations. The sum of total shareholders' equity and total liabilities is equal to the firm's total assets, which are the resources owned by the firm.







# Balance sheet example

Assets			Liabilities and Stockholders' Equity		
	2015	2016		2015	2016
Cash	\$ 94.50	\$ 90.00	Accounts payable	\$ 184.50	\$ 189.00
Accounts receivable	139.50	162.00	Accrued expenses	45.00	45.00
Inventory	229.50	378.00	Short-term notes	<u>63.00</u>	<u>54.00</u>
Other current assets	<u>13.50</u>	<u>13.50</u>	Total current liabilities	\$ 292.50	\$ 288.00
Total current assets	\$ 477.00	\$ 643.50	Long-term debt	<u>720.00</u>	<u>771.75</u>
Gross plant and equipment	1,669.50	1,845.00	Total liabilities	\$1,012.50	\$1,059.75
Less accumulated depreciation	<u>(382.50)</u>	<u>(517.50)</u>	Common stockholders' equity		
Net plant and equipment	<u>\$1,287.00</u>	<u>\$1,327.50</u>	Common stock-par value	45.00	45.00
Total assets	<u>\$1,764.00</u>	<u>\$1,971.00</u>	Paid-in capital	324.00	324.00
			Retained earnings	<u>382.50</u>	<u>542.25</u>
			Total common stockholders' equity	<u>\$ 751.50</u>	<u>\$ 911.25</u>
			Total liabilities and stockholders' equity	<u>\$1,764.00</u>	<u>\$1,971.00</u>

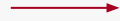


# The cash flow statement



We now move on to the third financial statement we want to review. The cash flow statement is a report, like the income statement and balance sheet, that firms use to explain changes in their cash balances over a specific period of time (i.e., one year or one quarter) by identifying all of the sources and uses of cash for that period.





# The cash flow statement



Thus, the focus of the cash flow statement is the change in a firm's cash balance for the period covered by the statement:

$$\text{Change in Cash Balance} = \text{Ending Cash Balance} - \text{Beginning Cash Balance}$$





# Sources and uses of cash



A **source of cash** is any activity that brings cash into the firm, such as when the firm sells goods and services or sells an old piece of equipment that it no longer needs. A **use of cash** is any activity that causes cash to leave the firm, such as the payment of taxes or the purchase of a new piece of equipment.

Sources of cash:		
Increase in accounts payable	\$ 4.50	
Increase in long-term debt	51.75	
Increase in retained earnings	159.75	
Total sources of cash		\$ 216.00
Uses of cash:		
Increase in accounts receivable	\$ 22.50	
Increase in inventory	148.50	
Increase in net plant and equipment	40.50	
Decrease in short-term notes	9.00	
Total uses of cash		<u>\$ 220.50</u>
Change in Cash Balance = Sources of Cash – Uses of Cash = \$216.00 – 220.50 \$ (4.50)		



# Statement of shareholders' equity



The statement of shareholders' equity provides a detailed account of activities in the firm's common and preferred stock accounts and its retained earnings account and of changes to shareholders' equity that do not appear in the income statement

	<b>COMMON STOCK</b>		<b>Retained Earnings</b>	<b>Total Stockholders' Equity</b>
	<b>Shares (000)</b>	<b>Amount</b>		
Balances, December 31, 2018	75,000	\$130.0	\$750.0	\$880.0
2019 Net income			146.3	
Cash dividends			(86.3)	
Addition to retained earnings				60.0
Balances, December 31, 2019	<u>75,000</u>	<u>\$130.0</u>	<u>\$810.0</u>	<u>\$940.0</u>

# Entrepreneurship Training Package

## Measuring Financial Performance

EUROTraining Educational Organization (PP2)

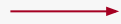




## → Financial ratios



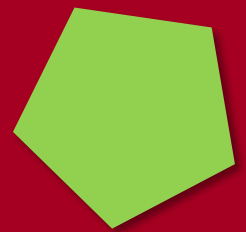
Financial ratios provide a quick and relatively simple means of assessing the financial health of a business. A ratio simply relates one figure appearing in the financial statements to another figure appearing there (for example, operating profit in relation to sales revenue) or, perhaps, to some resource of the business (for example, operating profit per employee).



# Financial ratios



By calculating a small number of ratios, it is often possible to build up a revealing picture of the position and performance of a business. It is not surprising, therefore, that ratios are widely used by those who have an interest in businesses and business performance. Ratios are not difficult to calculate; however, they can be difficult to interpret.



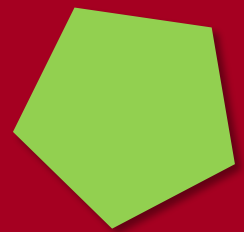




# Financial ratios



Ratios help us to identify which questions to ask rather than provide the answers. They help to highlight the financial strengths and weaknesses of a business, but cannot explain why those strengths and weaknesses exist or why certain changes have occurred. They provide a starting point for further analysis.



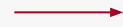


# Financial ratios classification



- **Profitability.** Businesses generally exist with the primary purpose of creating wealth for their owners. Profitability ratios provide some indication of the degree of success in achieving this purpose. They normally express the profit made in relation to other key figures in the financial statements or to some business resource.

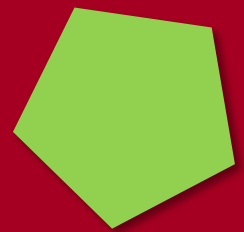




# Financial ratios classification



- **Efficiency.** Ratios may be used to measure the efficiency with which particular resources, such as inventories or employees, have been used within the business. These ratios are also referred to as activity ratios.



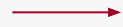


# Financial ratios classification



- **Liquidity.** It is vital to the survival of a business that there are sufficient liquid resources available to meet maturing obligations (that is, amounts due for payment in the near future). Liquidity ratios examine the relationship between the liquid resources held and amounts due for payment in the near future.





# Financial ratios classification



- **Financial gearing.** Gearing ratios are concerned with the relationship between the contribution to financing the business made by its owners and the contribution made by others, in the form of loans. They help to reveal the extent to which the business is reliant on loan finance.





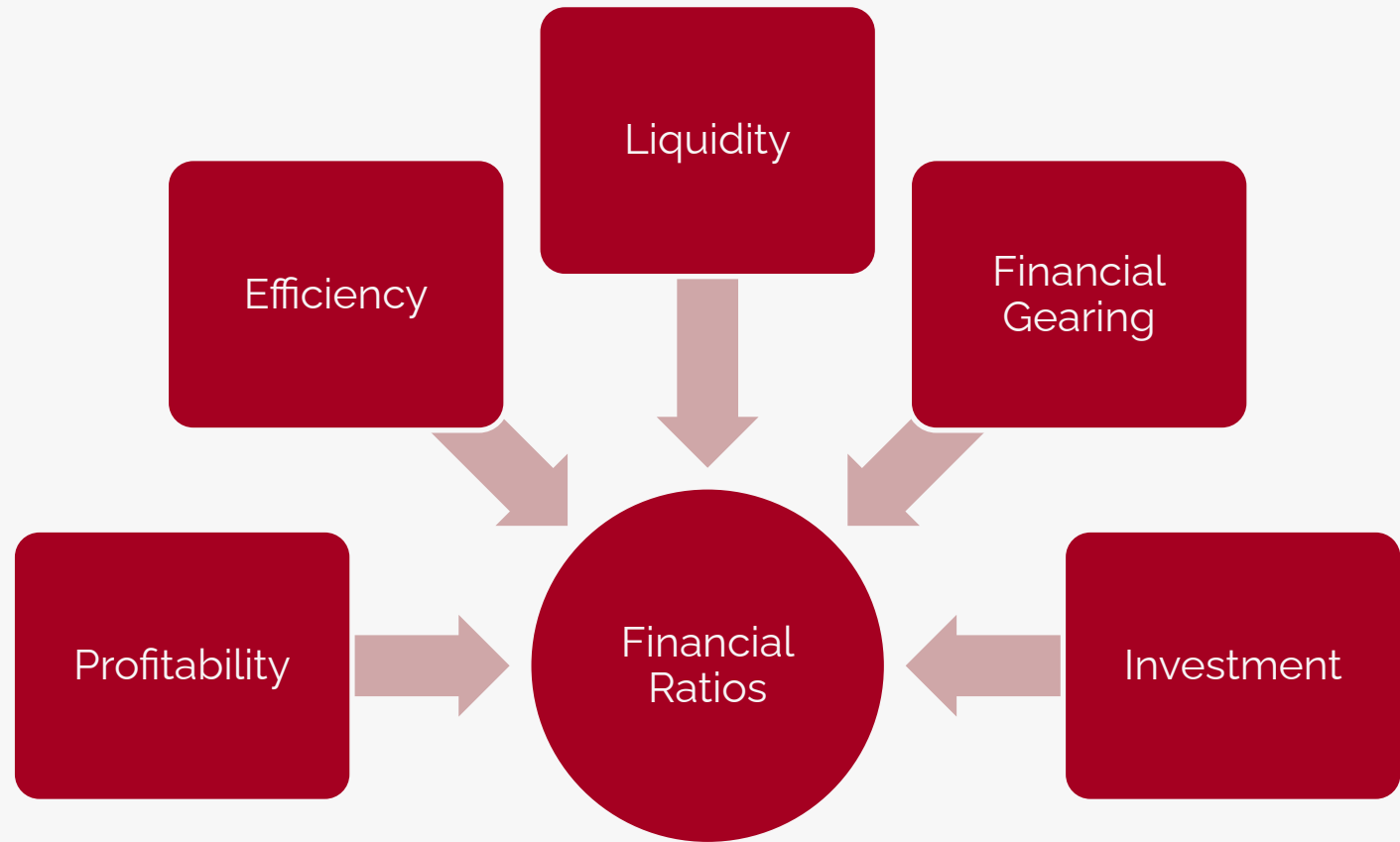
# Financial ratios classification

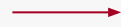


- **Investment.** These ratios are concerned with assessing the returns and performance of shares in a particular business from the perspective of shareholders who are not involved with the management of the business.



# → Key aspects of financial health

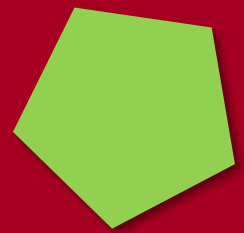




# The need for comparison



Merely calculating a ratio will not tell us very much about the position or performance of a business. If, for example, a ratio revealed that a retail business was generating 1,000 euros in sales revenue per square metre of floor space per month, it would not be possible to deduce from this information alone whether this particular level of performance was good, bad or indifferent. It is only when we compare this ratio with some 'benchmark' that the information can be interpreted and evaluated.







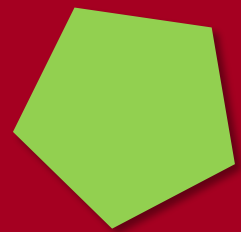
# The need for comparison

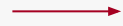


Can you think of any bases that could be used to compare a ratio you have calculated from the financial statements of a business for a particular period? *(Hint: There are three main possibilities.)*

You may have thought of the following bases:

- past periods for the same business
- similar businesses for the same or past periods
- planned performance for the business.



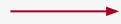


# Past periods



By comparing a particular ratio with the same ratio for a previous period, it is possible to see whether there has been an improvement or deterioration in performance. It is often useful to track particular ratios over time (say, five or ten years) to see whether any trends emerge.





# Past periods



Problems with comparison of past periods:

- trading conditions were quite different in the periods being compared
- operating inefficiencies may not be clearly exposed
- inflation may have distorted the figures on which the ratios are based

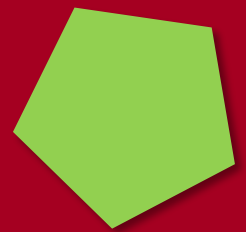


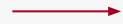


## Similar businesses



In a competitive environment, a business must consider its performance in relation to that of other businesses operating in the same industry. Survival may depend on its ability to achieve comparable levels of performance. A useful basis for comparing a particular ratio, therefore, is the ratio achieved by similar businesses during the same period.





# Similar businesses



Problems with comparison of similar businesses:

- Competitors may have different year-ends and so trading conditions may not be identical
- different accounting policies
- it may be difficult to obtain the financial statements of competitor businesses





## → Planned performance



Planned performance often provides the most valuable benchmark against which managers may assess their own business. Ratios based on the actual results may be compared with targets that management developed before the start of the period under review. This comparison can be a useful way of assessing the level of achievement attained. However, planned performance must be based on realistic assumptions if it is to be worthwhile for comparison purposes.

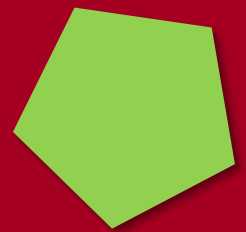




## → Planned performance

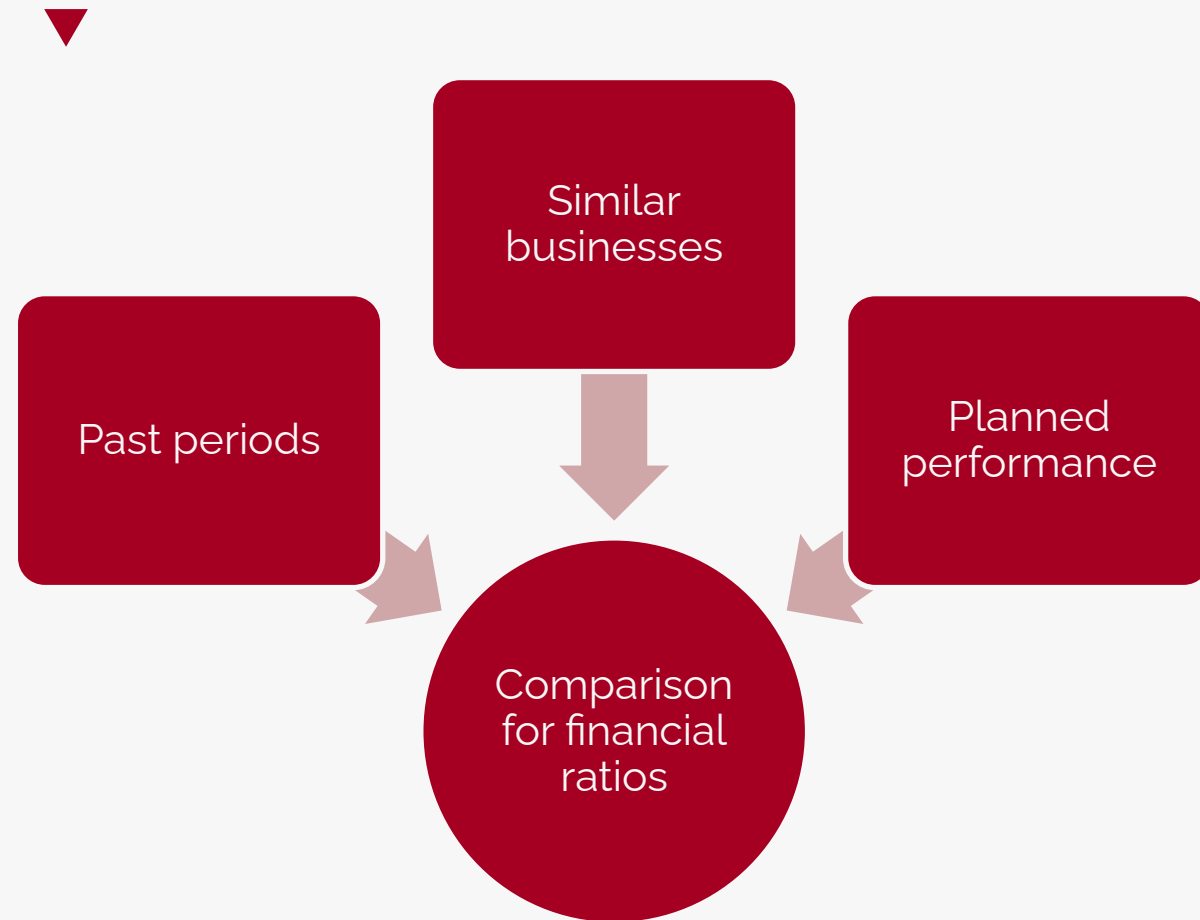


Planned, or target, ratios may be prepared for each aspect of the business's activities. When developing these ratios, account should normally be taken of past performance and the performance of other businesses. This does not mean, however, that a business should seek to achieve either of these levels of performance. Neither may provide an appropriate target.





## → Bases of comparison for financial ratios







# Profitability



The following ratios may be used to evaluate the profitability of the business:

- return on ordinary shareholders' funds
- return on capital employed
- operating profit margin
- gross profit margin.





## Return on ordinary shareholders' funds



The return on ordinary shareholders' funds ratio (ROSF) compares the amount of profit for the period available to the owners with the owners' average stake in the business during that same period. The ratio (which is normally expressed in percentage terms) is as follows:

$$\text{ROSF} = \frac{\text{Profit for the year less any preference dividend}}{\text{Ordinary share capital} + \text{Reserves}} \times 100$$



## Return on ordinary shareholders' funds



The easiest approach to calculating the average amount of shareholders' funds is to take a simple average based on the opening and closing figures for the year. Averaging is normally appropriate for all ratios that combine a figure for a period (such as profit for the year) with one taken at a single point in time (such as shareholders' funds).



# Return on capital employed



The return on capital employed ratio (ROCE) is a fundamental measure of business performance. This ratio expresses the relationship between the operating profit generated during a period and the average long-term capital invested in the business.

$$\text{ROCE} = \frac{\text{Operating profit}}{\text{Share capital} + \text{Reserves} + \text{Non-current liabilities}} \times 100$$

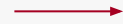


# Return on capital employed



ROCE is considered by many to be a primary measure of profitability. It compares inputs (capital invested) with outputs (operating profit) so as to reveal the effectiveness with which funds have been deployed. Once again, an average figure for capital employed should be used where the information is available





# Operating profit margin



The operating profit margin ratio relates the operating profit for the period to the sales revenue. The ratio is expressed as follows:

$$\text{Operating profit margin} = \frac{\text{Operating profit}}{\text{Sales revenue}} \times 100$$





## → Operating profit margin



This ratio compares one output of the business (operating profit) with another output (sales revenue). The ratio can vary considerably between different types of business. Factors such as the degree of competition, the type of customer, the economic climate and industry characteristics (such as the level of risk) will influence the operating profit margin of a business.

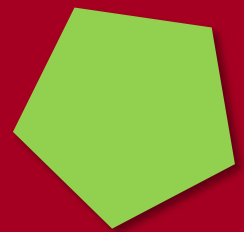


# Gross profit margin

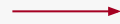


The gross profit margin ratio relates the gross profit of the business to the sales revenue generated for the same period. Gross profit represents the difference between sales revenue and the cost of sales. The ratio is therefore a measure of profitability in buying (or producing) and selling goods or services before any other expenses are taken into account

$$\text{Gross profit margin} = \frac{\text{Gross profit}}{\text{Sales revenue}} \times 100$$



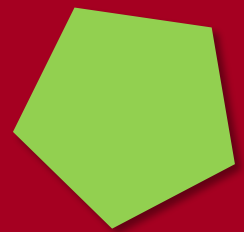




# Gross profit margin

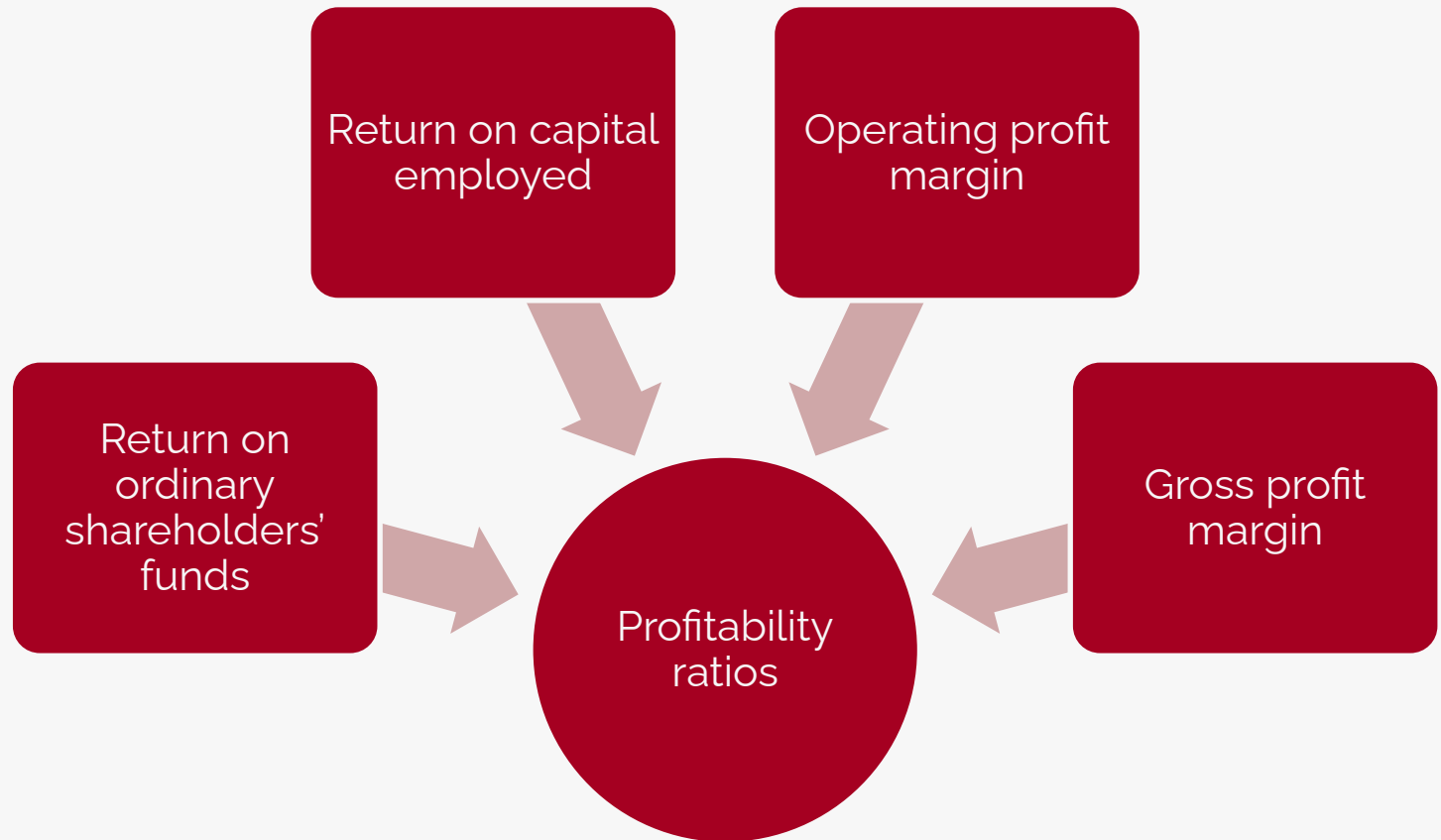


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## Profitability ratios



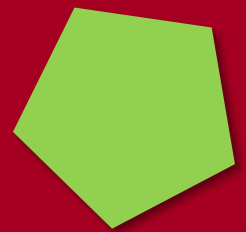




# Efficiency



Efficiency ratios are used to try to assess how successfully the various resources of the business are managed. The following ratios examine some of the more important aspects of resource management:

- average inventories turnover period
- average settlement period for trade receivables
- average settlement period for trade payables
- sales revenue to capital employed
- sales revenue per employee.







## Average inventories turnover period



Inventories often represent a significant investment for a business. For some types of business (for example, manufacturers and certain retailers), inventories may account for a substantial proportion of the total assets held. The average inventories turnover period ratio measures the average period for which inventories are being held.

$$\text{Average inventories turnover period} = \frac{\text{Average inventories held}}{\text{Cost of sales}} \times 365$$



## Average inventories turnover period



The average inventories for the period can be calculated as a simple average of the opening and closing inventories levels for the year. In the case of a highly seasonal business, however, where inventories levels may vary greatly over the year, a monthly average would be better.



## Average settlement period for trade receivables



The average settlement period for trade receivables ratio calculates how long, on average, credit customers take to pay the amounts that they owe to the business.

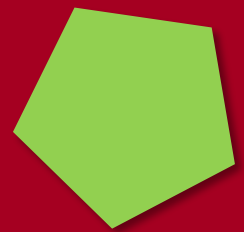
$$\text{Average settlement period for trade receivables} = \frac{\text{Average trade receivables}}{\text{Credit sales revenue}} \times 365$$



## → Average settlement period for trade receivables



Although this ratio can be useful, it is important to remember that it produces an average figure for the number of days for which debts are outstanding. This average may be badly distorted by, for example, a few large customers who are very slow or very fast payers.





## Average settlement period for trade payables



The average settlement period for trade payables ratio measures how long, on average, the business takes to pay those who have supplied goods and services on credit.

$$\text{Average settlement period for trade payables} = \frac{\text{Average trade payables}}{\text{Credit purchases}} \times 365$$

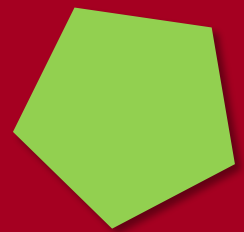




## → Average settlement period for trade payables



This ratio provides an average figure, which, like the average settlement period for trade receivables ratio, can be distorted by the payment period for one or two large suppliers. As trade payables provide a free source of finance for a business, it is not surprising that some businesses attempt to increase their average settlement period for trade payables. Such a policy can be taken too far, however, and result in a loss of supplier goodwill.





## → Sales revenue to capital employed



The sales revenue to capital employed ratio (or net asset turnover ratio) examines how effectively the assets of the business are being used to generate sales revenue.

$$\text{Sales revenue to capital employed ratio} = \frac{\text{Sales revenue}}{\text{Share capital} + \text{Reserves} + \text{Non-current liabilities}}$$



## Sales revenue to capital employed



Higher sales revenue to capital employed ratio is preferred to a lower one. A higher ratio will normally suggest that assets are being used more productively in the generation of revenue. A very high ratio, however, may suggest that the business is 'overtrading on its assets'; in other words, it has insufficient assets to sustain the level of sales revenue achieved.





## → Sales revenue per employee



The sales revenue per employee ratio relates sales revenue generated during a reporting period to a particular business resource, that is, labour. It provides a measure of the productivity of the workforce.

$$\text{Sales revenue per employee} = \frac{\text{Sales revenue}}{\text{Number of employees}}$$



# Sales revenue per employee

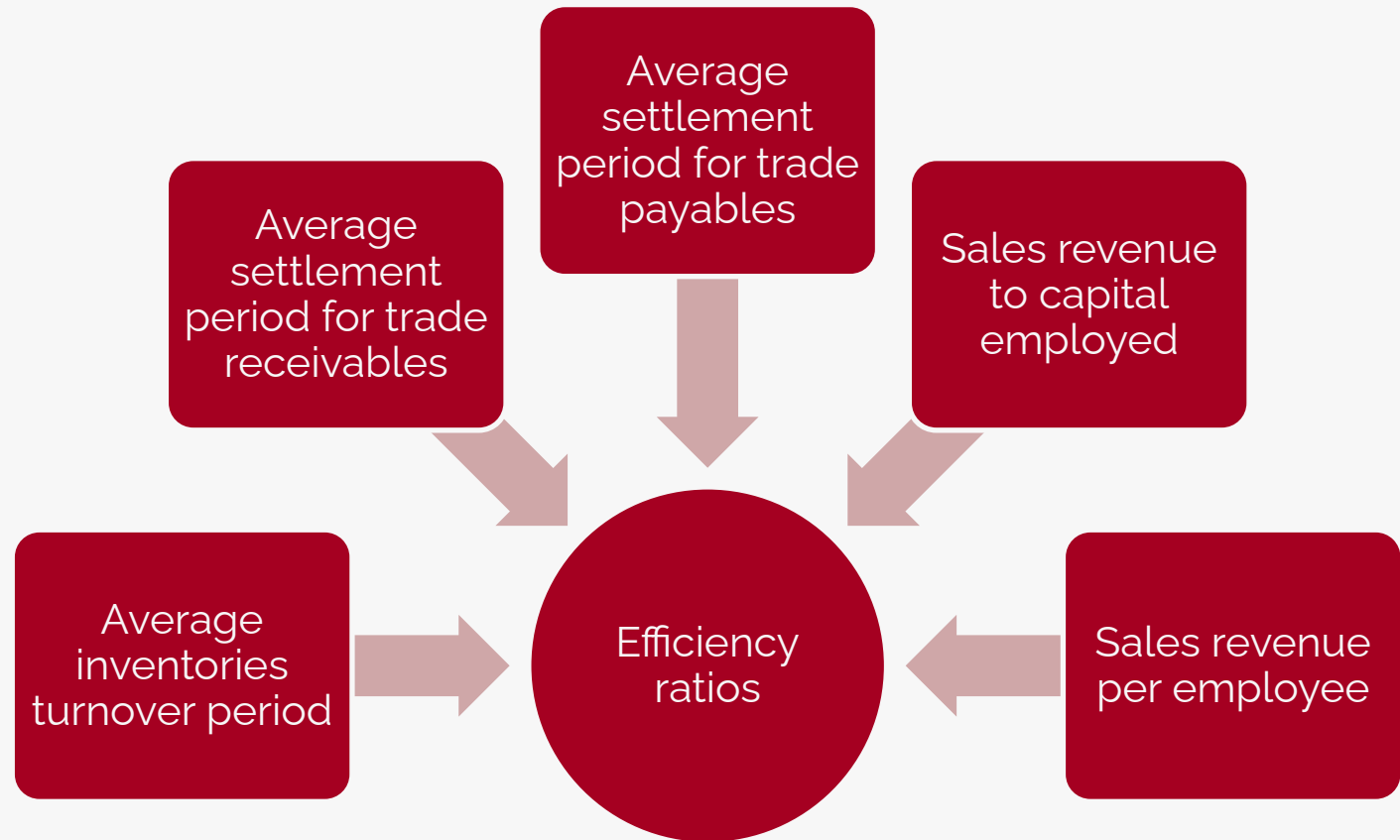


Generally, businesses would prefer a high value for this ratio, implying that they are deploying their workforce efficiently.





## → Efficiency ratios





# Liquidity



Liquidity ratios are concerned with the ability of the business to meet its short-term financial obligations. The following ratios are widely used:

- current ratio
- acid test ratio.



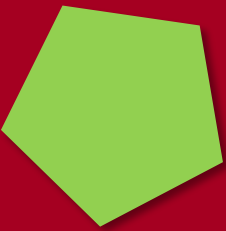
# Current ratio



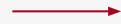
The current ratio compares the 'liquid' assets (that is, cash and those assets held that will soon be turned into cash) with the current liabilities.

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

The higher the current ratio, the more liquid the business is considered to be. As liquidity is vital to the survival of a business, a higher current ratio might be thought to be preferable to a lower one. If a business has a very high ratio, however, it may indicate that excessive funds are tied up in cash, or other liquid assets, rather than being employed more productively.







# Acid test ratio



The acid test ratio is similar to the current ratio but provides a more stringent test of liquidity. For many businesses, inventories cannot be converted into cash quickly.

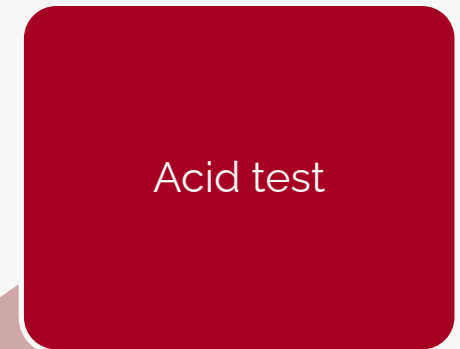
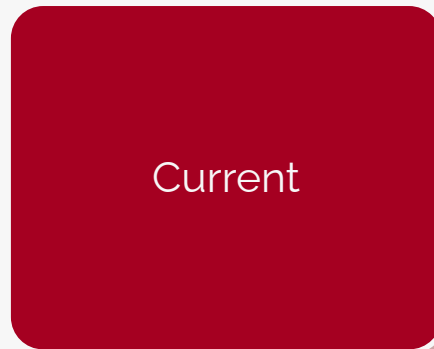
$$\text{Acid test ratio} = \frac{\text{Current assets (excluding inventories)}}{\text{Current liabilities}}$$

The minimum level for this ratio is often stated as 1.0 times (or 1:1). For many highly successful businesses, however, it is not unusual for the acid test ratio to be below 1.0 without causing liquidity problems.





## → Liquidity ratios



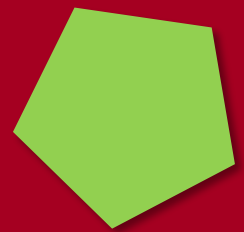


# Financial gearing



Financial gearing occurs where there is borrowing within the capital structure of a business. The existence of financial gearing can affect the risks and returns to ordinary shareholders. In order to measure the level of gearing, two ratios are widely used. They are as follows:

- gearing ratio
- interest cover ratio.





# Gearing ratio



The gearing ratio measures the contribution of long-term lenders to the long-term capital structure of a business.

$$\text{Gearing ratio} = \frac{\text{Long-term (non-current) liabilities}}{\text{Share capital} + \text{Reserves} + \text{Long-term (non-current) liabilities}} \times 100$$



# Interest cover ratio

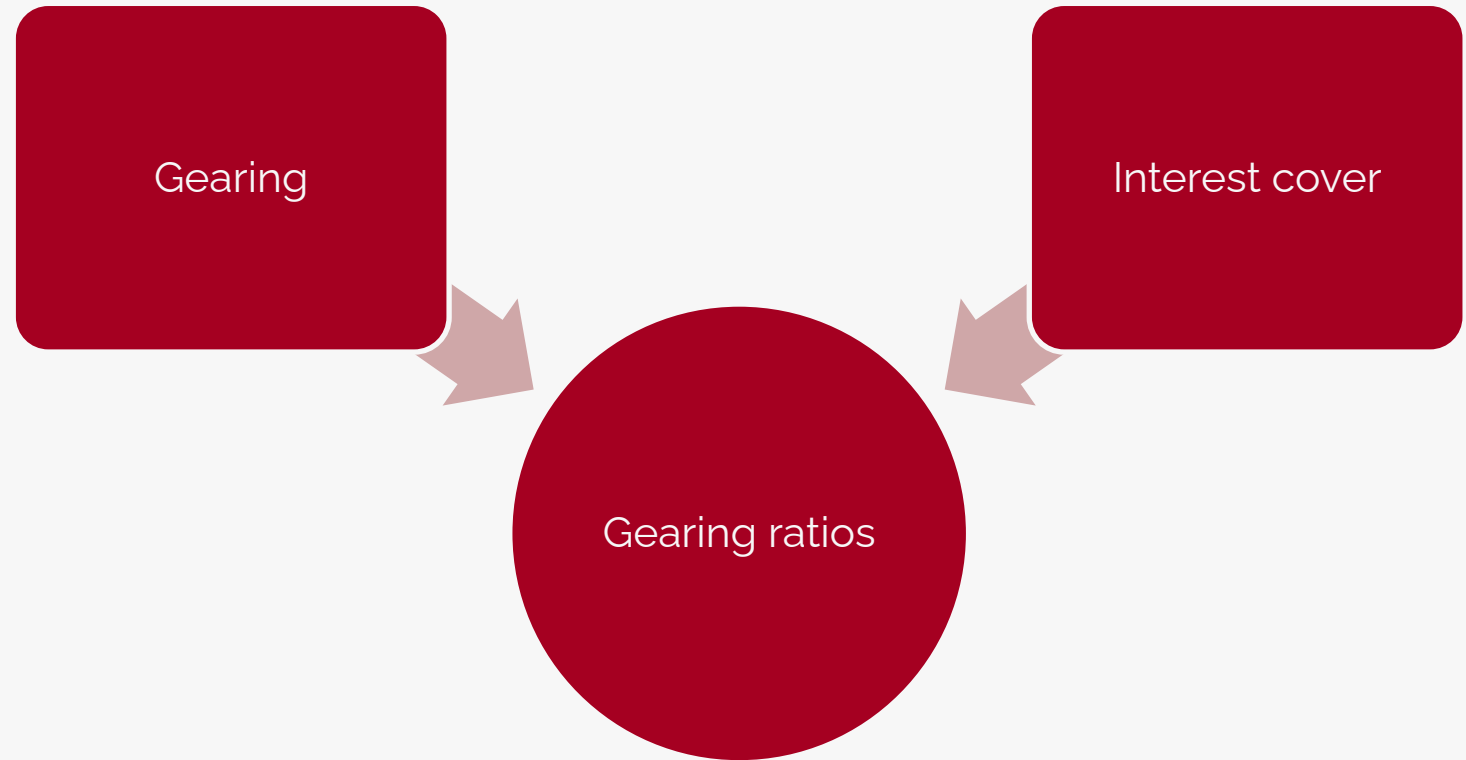


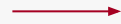
The interest cover ratio measures the amount of operating profit available to cover interest payable.

$$\text{Interest cover ratio} = \frac{\text{Operating profit}}{\text{Interest payable}}$$



# → Financial Gearing





# Investment ratios



Various ratios are available to help shareholders assess the returns on their investment. The following are widely used:

- dividend payout ratio
- dividend yield ratio
- earnings per share
- price/earnings ratio.





## → Dividend payout ratio



The dividend payout ratio measures the proportion of earnings that a business pays out to shareholders in the form of dividends.

$$\text{Dividend payout ratio} = \frac{\text{Dividends announced for the year}}{\text{Earnings for the year available for dividends}} \times 100$$

In the case of ordinary shares, the earnings available for dividend will normally be the profit for the year (that is, the profit after taxation) less any preference dividends relating to the year. This ratio is normally expressed as a percentage







# Dividend yield ratio



The dividend yield ratio relates the cash return from a share to its current market value. This can help investors to assess the cash return on their investment in the business.

$$\text{Dividend yield} = \frac{\text{Dividend per share}}{\text{Market value per share}} \times 100$$



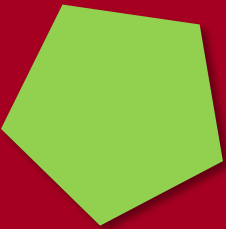


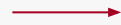
# Earnings per share



The earnings per share (EPS) ratio relates the earnings generated by the business, and available to shareholders, during a period to the number of shares in issue. For equity (ordinary) shareholders, the amount available will be represented by the profit for the year (profit after taxation) less any preference dividend, where applicable.

$$\text{Earnings per share} = \frac{\text{Earnings available to ordinary shareholders}}{\text{Number of ordinary shares in issue}}$$

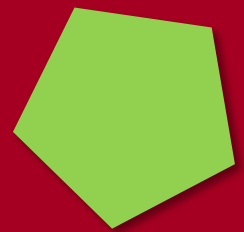




# Earnings per share



Many investment analysts regard the EPS ratio as a fundamental measure of share performance. The trend in earnings per share over time is used to help assess the investment potential of a business's shares. Although it is possible to make total profit increase through ordinary shareholders investing more in the business, this will not necessarily lead to an increase in the profitability per share.





## → Price/earnings (P/E) ratio



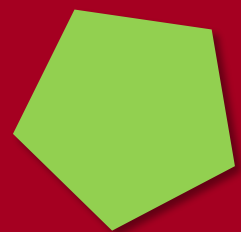
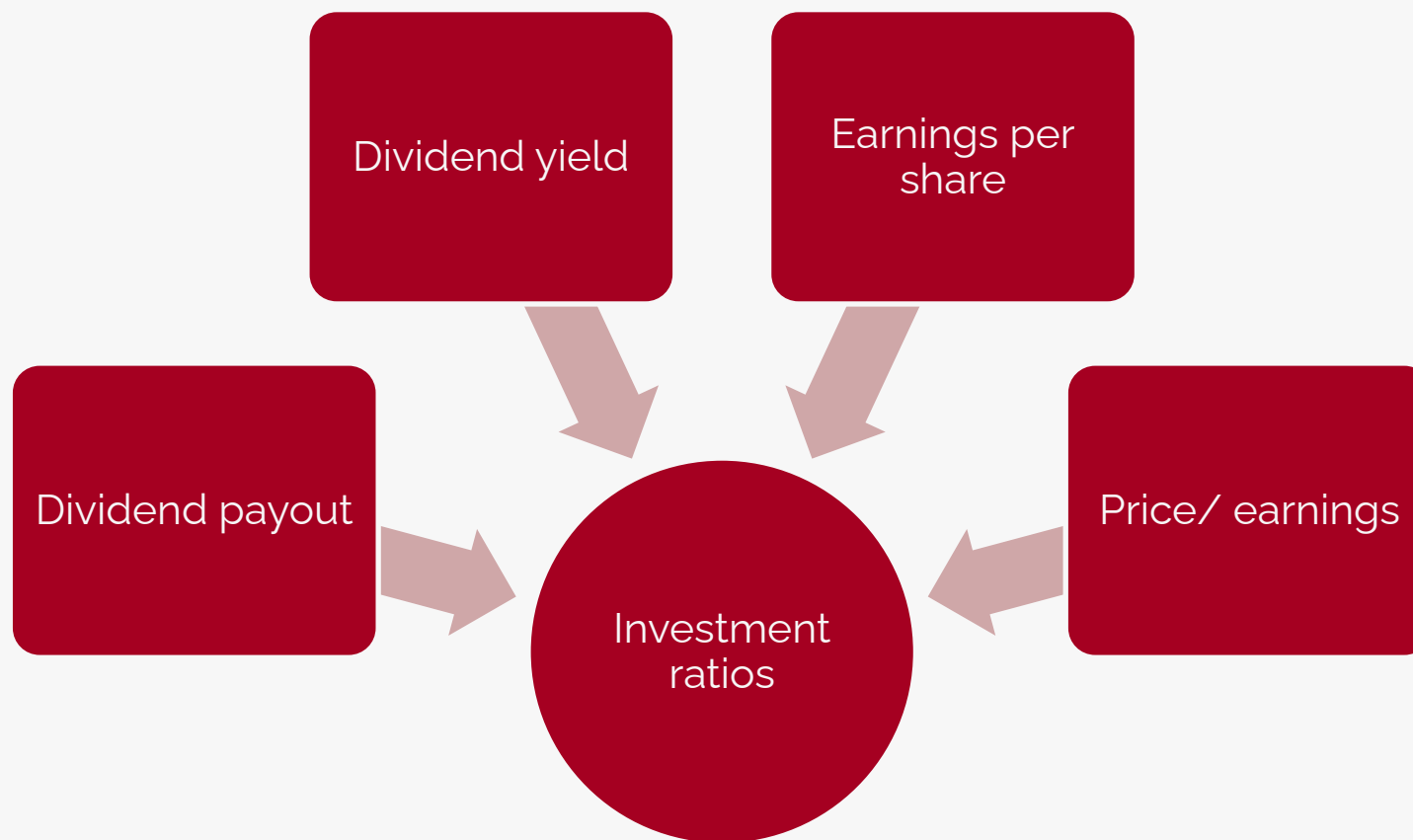
The price/earnings (P/E) ratio relates the market value of a share to the earnings per share.

$$\text{P/E ratio} = \frac{\text{Market value per share}}{\text{Earnings per share}}$$

The higher the P/E ratio, the greater the confidence in the future earning power of the business and, consequently, the more investors are prepared to pay in relation to that current earning power.



# → Investment



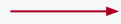


# Overtrading



Overtrading occurs where a business is operating at a level of activity that cannot be supported by the amount of finance that has been committed. This situation is usually due to poor financial control over the business by its managers.





# Overtrading



It may occur:

- in young, expanding businesses that fail to prepare adequately for the rapid increase in demand for their goods or services. This often leads to insufficient finance to fund the trade receivables and inventories needed to support the additional sales generated
- in businesses where the managers may have misjudged the level of sales demand or have failed to control escalating project costs



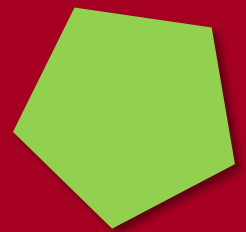


# Overtrading



It may occur:

- as a result of a fall in the value of money (inflation), causing more finance to be committed to inventories and trade receivables, even where there is no expansion in the real volume of trade
- where the owners are unable to inject further funds into the business and/or they cannot persuade others to invest in the business.







## → Overtrading



To deal with the overtrading problem, a business must ensure that the finance available is consistent with the level of operations. Thus, if a business that is overtrading is unable to raise new finance, it should cut back its level of operations in line with the finance available. Although this may lead to lost sales and lost profits in the short term, cutting back may be necessary to ensure survival over the longer term.



# Entrepreneurship Training Package

## Capital budgeting

EUROTraining Educational Organization (PP2)





# → Capital budgeting



Although the capital-budgeting process can be long and complicated at many major corporations, we can sum up the typical capital-budgeting process at any firm in terms of two basic phases:

- **Phase 1:** The firm's management identifies promising investment opportunities. These opportunities generally arise from ideas generated by the management and employees of the firm. Employees who work closely with the firm's customers (generally, the marketing department) or who run the firm's operations (the production management department) are often the idea generators.

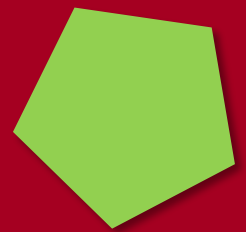




# Capital budgeting



- **Phase 2:** Once an investment opportunity has been identified, its value-creating potential—what some refer to as its value proposition—is thoroughly evaluated. In very simple terms, a project's value proposition answers the following question: "How do we plan to make money?" It is at this stage that financial analysts enter the picture.



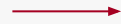


# Types of Capital Investment Projects



Capital investment projects can be classified into one of three broad categories:

1. Revenue-enhancing investments
  2. Cost-reducing investments
  3. Mandatory investments that are a result of government mandates
- 



# Net Present Value



The analysis of most investments requires to also consider the time value of money. In other words, instead of simply calculating the profits of the investment, one must calculate the investment's net present value.

The net present value (NPV) is the difference between the **present values** of the **cash inflows** and the **cash outflows**. As such, the NPV estimates the **amount of wealth** that the project **creates**.

The NPV criterion simply states that an investment project should be accepted if the NPV of the project is positive and should be rejected if the NPV of the project is negative





## → Other Investment Criteria



Although the NPV investment criterion makes the most sense in theory, in practice financial managers use a number of criteria to evaluate investment opportunities, such as:

- **Profitability Index:** the cost-benefit ratio equal to the present value of an investment's future cash flows divided by its initial cost
- **Internal Rate of Return** of an investment is analogous to the yield to maturity (YTM) on a bond
- **Modified Internal Rate of Return:** The idea behind the MIRR is to rearrange the project cash flows so that there is only one IRR. We do this by modifying the project cash flows so there is just one change in the sign of the cash flows over the life of the project.
- **Payback Period** for an investment opportunity is the number of years needed to recover the initial cash outlay required to make the investment



# Discussion & Remarks



IDEAS



REMARKS

SUGGESTIONS



FURTHER  
QUESTIONS





Thank you for  
your attention

