

Managing financial resources and decisions essay sample

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Executive Summary

Managing financial resources and decisions is a concept of managing the finances of a company for running it efficiently and making decisions which are best fit for the company's current working and position. The assignment covered analysis Living Wood Ltd, a furniture manufacturer. With the help from the cash budget prepared, I found that Living Wood is not producing as efficiently that they could be. They have many resources available to them, that could assist the company in improving their current state, however they are not employing them. Detailed analysis of Living Wood is conducted further in the Assignment.

Introduction

Living Wood Ltd is a private limited company that was set up by three carpenters, Billi kid, Bengazy and Lee Jones. It is a medium-sized company that produces furniture for the retail sector and private homes, and is mainly in the domestic market. Living Wood has been in business for five years, and employs around two hundred staff. The three founders are extremely enthusiastic about their designs and furniture, however, they are unable to integrate other business functions like marketing, administration or sourcing of materials at best prices. Their Operations Director, Mathew Doit, is keen about introducing new practices that focus on attitude, values and working practices. According to him, these new ideas could improve the growth of Living Wood through total quality management.

PART 1

1a) Identify the sources of finance available to Living wood. 1b) Why would

some sources of finance be more appropriate or better in some situations than the others? 1c) Why is financial planning important to Living wood?

1d) How does it help decision making?

1a) Living wood, a private limited company, has been in business for the last five years. It manufactures furniture for the retail sector and private homes. Currently, it is classed as a medium sized business, with 200 employees. The company's market share has fallen by 1%, and they need to widen their product range. To do so, Living wood needs to buy new machinery worth £5 million. To raise this capital Living wood could go in for a long term bank loan, as the amount they require is very large. Living wood could even hire purchase the equipment. This will minimize the risk of a bad investment, as Living Woods is able to return the machinery if it does not work out as planned. Since Living wood is a private limited company, they could sell shares to their family and friends.

1b) There are many different sources of finance available for businesses. Some are more appropriate for certain businesses than others. This is because businesses are of different types, and sizes. To raise the required capital Living wood could go in for a loan. A long term loan would be best in this case. As £5 million is a very large amount, Living wood will not be able to repay that within a year if they went in for a short term loan. Their records show that the net profit for year 2010 is only £370000, from which they will most certainly not be able to repay £5 million in a year. A bank overdraft would be very unsuitable as bank overdrafts are only beneficial for a short period of time. Bank overdrafts have high interest rates, so are better for

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smaller amounts. Living wood requires £5 million; this would incur a huge charge as interest that could possibly end up being higher than the principal itself. Living wood could even hire purchase the equipment.

This way they would be able to pay for the equipment over a period of years, and the burden of the investment will be felt less over the years. This will also minimize the risk of a bad investment, as Living Woods is able to return the machinery if it does not work out as planned. Though, in some cases, the cost of hire purchasing equipment ends up to be much higher than the initial amount. Living wood could possibly raise capital by selling their fixed assets; however this might not be the best decision. The fixed assets could include land and machinery. While selling these assets could bring in a significant amount of capital, they may find a better use for these in the long run. In the case of land, Living wood probably bought it in the first place with hopes of expanding in the future. Also, the machinery they have would be around five years old, and may not bring as much finance they will require, and they will also need to find a replacement for it which will again require more capital. Living wood has the option of selling their debts to a debt factoring company.

This would allow them to have more cash in hand quicker. On the other hand, their current debtors are not very high. They also would have to pay the debt factoring company a fee for the transaction, Living wood cannot afford to do this as they need to raise capital. As Living wood is a private limited company, they could sell shares to their close family and friends. With this they will also need to give the shareholders a share of the profits

which may be considered as a liability. But since the new machinery is said to improve productivity they will be able to afford it, so selling shares might actually be a good option. 1c) Financial Planning is process of framing objectives, policies, procedures, programmes and budgets regarding the financial activities of a concern.

This ensures effective and adequate financial and investment policies.

According to Michael Armstrong in his book “ The Handbook of Management Techniques”, a Financial Plan predicts the performance of the business in financial terms to give an overall measure of how it is performing and to provide a basis for financial decision making and for raising finance.

Performing Financial Planning is critical to the success of any organization. It provides the Business Plan with accuracy, by verifying that the objectives set are attainable from a financial point of view. It assists in setting financial targets for the organization.

Figure 1: Components of a financial statement

The three main components of a financial statement are the Cash Flow Statement, the Income Statement (also referred to as the Profit and Loss account), and the Balance Sheet. The three statements are interlinked; this means that changes in one will definitely change the others. However, the three statements measure different features of the company. The income statement is a report depicting Living wood’s cash generating ability. It will show the company its revenues, expenses, capital, and the cost of goods bought in. This will allow Living wood to be able to establish how much profit or loss they made during the year. The cash flow statement is one of the

most important records of information for any company. This statement shows the how cash will come into and out of the business. It will provide Living wood with figures about how much cash will be required, when the cash will be needed, and from where it will be generated from.

The cash flow statement is a powerful indicator of future profits or losses. It is essential for Living wood to be able to understand whether the business is in a risk of running losses, this statement will tell them if they need additional cash. The statement helps in ensuring a balance between outflow and inflow of funds so that the business remains stable. The balance sheet, unlike the other two statements, is formed on an annual basis, and acts as a summary of all the financial data divided into three areas: Assets, Liabilities, Equity. Living wood will be able to determine the company's net worth and their financial position with the help of a balance sheet. Living wood is anticipating an increase in demand as well as new contract. They need new machinery that will cost £5 million, which will help them widen their range of products. For this, they will require a strong financial plan.

Living wood will have to produce more units of furniture; these may not be sold immediately as the economy is facing a downturn. In the meantime, they will have to make some financial arrangements to sustain the business until the market begins to pick up again. So, Living wood will need more capital as stock holding costs. The financial plan will show them the predicted inflow and outflow of cash, with this Living wood will be able to decide the actions that will be taken in the future. Living wood does not anticipate demand well according to the case. This causes them to buy raw

materials from any supplier available, which in turn affects the quality and increases the cost as well. The financial plan will help them to have a steady supply of raw material available for future rise in demand, and reduce uncertainties. Additionally, having a stable supplier will allow them to reduce costs.

1d) Decision making can be referred to as the mental processes resulting in the selection of a course of action among several alternative scenarios. As defined by Baker et al in their 2001 study, “ efficient decision-making involves a series of steps that require the input of information at different stages of the process, as well as a process for feedback”. A systematic and logical decision making process helps you to address the crucial elements that result in a good decision. Decisions that are based on a foundation of knowledge can lead a company towards success, while decisions that are based on incomplete information can put them out of business. Any decisions taken are based on qualitative and quantitative information.

Financial planning is essential for decision making as a business cannot function without a stable financial plan. Without efficient decisions, a business would not be able to progress effectively. The Financial Plan helps to know the exact position of the business, that is, where it stands with its competitors. It also shows the business’s liabilities and investments. For example, if a business wanted to make a large investment, this decision would take into consideration many financial factors that the financial plan would aid in, starting with how much it would cost, to the returns would the

company gain from in the years to come. As Living wood does not have an up to date MIS system, anticipating demand is difficult for the company.

Market research will help them to predict the future trends in the demand of furniture. With efficient sales forecasting, Living wood will be able to forecast their cash flows effectively, in turn benefiting the financial planning. Living wood needs to recover its market position. To do this, they must increase their product range. They are planning to buy new machinery worth £5 million, which will help them in producing a wider range of products, and improving productivity. Living wood, like any other business, needs a financial plan. This plan will show Living wood how many years until they start to see returns on the investment they made in the machinery. The financial plan will present their predicted future cash inflows and outflows, therefore allowing Living wood to decide whether or not they can afford the machinery and if it is a good investment.

PART 2

2a) Using the appropriate ratios calculate and analyse the performance of the company during the last 2 years. 2b) How does this financial statement differ from the other financial statements you are familiar with?

2a) Author Shyam Bhatawdekar defines financial ratio analysis as ‘ a systematic use of ratio to interpret the financial statements so that the strengths and weaknesses of a firm as well as its historical performance and current financial condition can be determined.’ He goes on to say that ‘ Ratios make the related information comparable. A single figure by itself has no meaning but when expresses in terms of a related figure, it

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yields significant inferences.’. He means that numbers in a financial statement solely are often of limited significance. The real information can be found in an analysis of the correlation of one number to another, using ratios. The following are the four major categories of ratios, and the eight basic ratios from the categories: 1. Liquidity measures- Current Ratio

2. Capitalization measures- Financial Leverage, Long-Term Debt to Capital 3. Activity measures- Assets Turnover per Period, Inventory Turns per Period, Days Sales in Inventory 4. Profitability measures- Return on Sales, Return on Capital Employed Ratios, however, do have their limitations. Their reliability depends upon the consistency of the original records. Changes in prices also interfere with the comparisons made. False conclusions may be determined due to small errors or window dressing of original records. (Assuming that the first column of data is for the year 2010, and the second column is for the year 2009) Ratios

2010

2009

Net Profit Margin (NP/Sales*100)

7. 41%

8. 47%

ROCE (NP/Capital Emp.*100)

20. 00%

26. 84%

Current Ratio (CA/CL)

1. 95

1. 56

Acid Test Ratio (CA-Stock/CL)

1. 09

0. 84

The Net Profit Margin is a measure of profitability. It is calculated with the net profit as a percentage of the turnover. The net profit margin of a company suggests how well it controls its costs. While comparing the Net Profit margins, it can be said that in 2009 Living Woods did relatively better than in 2010. The net profit in 2009 was 37. 8% more than in 2010. Also, the sales had decreased by 20. 6% in 2010. These results indicate that Living wood was better controlling its costs in 2009 than in 2010. This could be as a result of various reasons; the overhead expenditure could have been much lower in 2009, this could mean that perhaps Living Woods managed to be more efficient in 2009 than in 2010. The sales could have been more in 2009 because of a greater demand; the demand in 2010 could have decreased due to economic conditions. It is impossible to evaluate the profits appropriately without relating them to the amount of capital that was invested in generating these profits.

The Return on Capital Employed shows how much net profit was generated in comparison with the total capital employed represented as a percentage. With this, we can see that the company did significantly better in 2009. Although in 2009, Living Woods did employ more capital, the total difference between the two years is only of 6. 84%, while the difference between the retained earnings is 37. 8%. This shows how the company managed to be so

much more efficient with their capital in 2009. (The data given is not complete. The assumption is that no dividend has been declared, and the entire profit has been reinvested into the business.) The Current Ratio is an indication of the liquidity of a business, that is, the ability for it to be able to pay its short term liabilities with its short term assets. It can also act as a measure of the company's ability to meet creditor's deadlines. A current ratio of 1.5 or greater than 1.5 is generally favourable. If current ratio is too low, the company will have problems meeting its short term liabilities. However, if the current assets are far greater than the short term liabilities, the company may not be efficiently using its current assets.

The calculations show that in both years, Living wood had a current ratio greater than one. In 2010, the ratio was 1.95: 1, this shows that for every pound the company owes in the short term it has £1.95 available in assets that can be converted to cash. Given in 2010 the company did do better, however in 2009 they still had a good short term financial strength had any emergency occurred. Companies are not able to convert all their current assets into cash very fast. They might hold large quantities of raw material stocks, finished good stocks might be warehoused for a long time. In such businesses where stock turnover is slow most stocks are not very liquid assets, meaning that they cannot be easily turned into cash. For these reasons we calculate the Acid Test ratio.

The Acid Test ratio is evidence that indicates if a firm has enough short-term liquid assets to pay its immediate liabilities. It is usually said that companies with ratios of less than 1 cannot pay their current liabilities and should be

looked at with extreme care; however a ratio of 0.8 is generally accepted. In 2009, Living Woods may have had some financial problems while trying to pay off their liabilities, as the ratio for that year was only 0.84. But perhaps, this was just an alarm for the business to manage the finance more efficiently than anything that showed major losses. Looking at the ratios for both years, it can be said that Living wood's liquidity has improved in 2010 than 2009.

2b) A financial statement consists of Balance Sheet, Trading and Profit and Loss Account, and Cash Flow Statement. A Trading and Profit and Loss account is a record of income generated and the expenditure over a period of time. Profit and Loss Statement is a financial statement for a company which indicates how revenue is converted into income. It is divided into three parts: the Trading account, the Profit and Loss account, and the Appropriation account. Here is an example of a profit and loss account divided into the three parts:

Figure 3: Components of a Profit and Loss account

(Source: RJA, (2007), profitandlossqq0 [ONLINE]. Available at: <http://img210.imageshack.us/img210/1589/profitandlossqq0.jpg> [Accessed 10 March 11])

The objective of the profit and loss account is to show managers of Living wood whether the company has made or lost money during the period. This statement should help determine the past performance of the enterprise; predict future performance; and assess future cash flows. The format for a limited company like Living wood would be different. In a limited company, the term used for sales is turnover, and the costs are broken down into

headings like Distribution costs, Administrative Costs, Interest Payable, and Taxation. Here, the net profit is represented as the retained profit for the year.

As limited companies have dividends to pay, the Profit and Loss statement would show the share dividends paid for preference and ordinary shares. Dividends do not appear in that of a sole trading or partnership business, instead sole traders get all the profits earned, and the owners of a partnership will receive a share of the profit and will be reflected in their individual capital accounts. In an unincorporated business, the expenses are expressed in greater detail. Also, unincorporated businesses do not qualify for corporation tax, so will not be present in any accounts. They pay personal income tax on their share of profits; however, this is not shown in financial statements of the business. The Balance Sheet shows the Living wood's assets, liabilities, and their equity. The three main components of a balance sheet: Assets, Liabilities, and Capital. The top part represents Net Assets of the business and will be similar for all types of businesses.

The bottom part represents owners' stake in the business. In a company, the owners are shareholders whose initial investment is shown as share capital. In a partnership, the partners' individual investments are represented by separate capital accounts and current accounts. For sole traders, the profits are often transferred into the capital account, so the Balance sheet only have headings as opening capital and closing capital. The Balance Sheet of a limited company shows the assets as Tangible and Intangible. Limited company Balance Sheets also show the investments made during the year

as a separate heading. The Current Liabilities and Long Term Liabilities are termed as creditors: amounts falling due within one year and creditors: amounts falling due after more than one year. In the Capital and Reserves of a limited company, the share capital, share premium, general reserve, and the retained profit are generally shown.

As a sole trading and partnership business does not have shares, only the capital employed for the year will be shown under the Capital. Cash flow refers to the amount of cash being received and spent by a business during a defined period of time. The cash flow statement reports the significant elements of cash generation and cash absorption for a period. Measurement of cash flow can be used to analyse the condition or performance of a business, to resolve problems with liquidity. Being profitable does not necessarily mean being liquid. A company can fail because of a lack of cash, even while profitable.

The time of cash flows into and out of projects are used as inputs to financial models such as internal rate of return, and net present value. With a Cash Flow Statement, Living wood is able to determine how much cash and when it is flowing into and out of the business. This information can further be used to take future decisions, such as investing in the new machinery they need. With a cash flow statement we can see that the changes in the cash balance had to result from changes in assets liabilities and owners equity. The assets and liabilities changes came from the balance sheet. The changes in the owner's equity were the result of changes in the net income provided by the Profit and Loss account.

PART 3

3a) Explain the nature and purpose of the material and labour variances 3b)

Calculate the material and labour variances from the data given 3c)

Comment on variances calculated

3a) The difference between actual results and expected results is a variance.

When actual results are better than expected results given variance is

described as favorable variance. When actual results are worse than

expected results given variance is described as adverse variance, or

unfavorable variance Material variance is the difference between the actual

total cost of the actual number of units produced and its budgeted cost in

terms of materials. This variance tells us how efficiently the material was

used in producing the output. A material variance may be caused by the

price paid for material being more or less than the standard, caused due to

unpredictable fluctuation in prices, higher transport costs, or an increase in

duties. The variance could also be caused by the quantity of material used

for each unit made being more or less than the standard.

Other reasons could be because of a cash discount taken, or the difference in

the quality of materials bought. A Labour variance is the difference between

the standard cost for actual production and the actual cost in production.

This variance tells us how efficient the labor was in producing the actual

output. A total labor variance may be caused by the hourly rate being paid to

workers being more or less than the standard, this could be as a result of an

increase in wages or even excessive overtime with overtime premium

charged to direct labor costs. A labour variance could also be caused by the

time taken for production being more or less than standard, this could be due to machine breakdown or materials not being available. The purpose of the material and labour variances is to control the cost of direct materials, to assess the performance of the purchasing department, to calculate the effect of price increases or decreases on the profit of the company, and to evaluate efficiency of workers.

3c) The material costs for sofa no. 123x were actually £110 per sofa which is £2 more than the budgeted cost. This, in total, is an adverse price variance of -11%. This could be because of an increase in the price of material per kilogram. Also the quality of the material may have improved causing the price to go up. That would also explain the 8% favourable variance in the material usage. Living woods used 1kg less material per sofa than the expected amount. Another reason for this variance could be that Living wood had cut down on their material wastage or even that they made a more efficient use of the materials they had because of a stricter quality control. The labour rate variance is an adverse -10%. This is an increase of £9.30 per sofa, a total increase of £2232 for 240 sofas. This variance could be as a result of an increase in the wages of employees. The employees could have worked over time, causing Living wood to pay them more including the overtime premium charged to the direct labour costs. However, the labour efficiency variance is also adverse. This variance of -5% could have resulted from wasteful work being done, also causing an adverse labour rate variance. The output of the sofas could have been lower than the budgeted number, or may have taken a much longer time to produce the required units.

PART 4

4a) Living wood makes a single chair with a selling price of £15 and a variable cost of £12. Fixed costs are £5400 per annum. Calculate the breakeven points in units and in £'sales value. Sales = Variable expenses + Fixed expenses + Profit

$$£15Q = £12Q + £5400 + £0$$

$$£3Q = £5400$$

$$Q = £5400 / £3$$

$$Q = 1800 \text{ units}$$

$$1800 * 15 = £27000$$

Breakeven point in units = 1800 units

Breakeven point in £'sales value = £27000

Figure 4: Breakeven chart for Living wood

4b) Calculate the contribution to sales ratio.

Contribution to Sales ratio = Contribution/Sales *100

Contribution = Sales per unit - Variable Costs per unit

Contribution of one unit = £15 - £12 = £3

Contribution of 1800 units = £3 * 1800 = £5400

Contribution to Sales ratio = £5400/£27000 * 100 = 20%

4c) What level of sales will achieve a profit £8, 400?

Living wood will be able to achieve a profit of £8400 when they sell 4600 units. Units Sold

Total Revenue (£)

Total Cost (£)

Variable Cost (£)

Fixed Cost (£)

Profit (£)

4600

69000

60600

55200

5400

8400

4d). The variable cost is expected to increase to £13 per unit and fixed costs to £6000 per annum. If selling price remains unchanged, how many units are required to maintain the profit of £9000? To maintain a profit of £9000 with an increase in the variable cost as well as the total cost, Living wood would need to sell 7500 units. Units Sold

Total Revenue (£)

Total Cost (£)

Variable Cost (£)

Fixed Cost (£)

Profit (£)

7500

112500

103500

97500

6000

9000

Figure 5: Revised breakeven chart for Living wood

4e) Using the payback, ARR, the net present value and the internal rate of return methods advise Living wood whether they should borrow funds to purchase the two machines.

Net Cash Flows

Year (t)

Machine A

Cumulative Profit/Loss

Machine B

Cumulative Profit/Loss

Payback period calculates the amount of time a project will take to earn back the initial investment. For Machine A, Living wood would start receiving returns after just 2.5 years, whereas with Machine B they would have to wait for 4 years to receive any returns. With this data, Living wood would be better off not borrowing money for Machine B as they would have to pay back the bank for more years and pay a higher amount as interest.

ARR stands for the Accounting Rate of Return. It calculates the profits that will be earned by a project. The higher the rate of return the higher a project is ranked. As Machine A has a higher ARR, it is worth their while to invest in it since Machine B is only giving 1% returns.

If the NPV is positive the present value of benefits surpasses the present value of costs. This means the project will earn a return in excess of the cost of the capital. The project will therefore be accepted. If the NPV is negative, the project will earn a return lower than the cost of capital and will not be worth investing in. Looking at Machine A, it can be seen that the NPV is a positive £324.73. Machine B, however, is negative £353.01. It would not be a good business decision for Living wood to invest in Machine B as they are losing £353.01 over the cost of capital.

IRR involves comparing the rate of return anticipated from the investment calculated on a discounted cash flow basis with the rate used as the cost of capital. Projects with an IRR higher than the cost of capital are worth undertaking. The IRR for Machine A is much higher than that of Machine B. While Machine B only gives Living wood a return of 2%, Machine A gives them 18% which is favourable. After comparing the data for Machines A and B, we can say that Machine A will be the more beneficial investment for Living wood, and that they should borrow money for Machine A.

6) The cash budget shows that Living wood is not doing too well financially. However, from Profit and Loss Account we can see that they did in fact make a reasonable amount of profit, which was £510000 in 2009, and £370000 in 2010. So it can be said that the company may have made a lower amount of profit than the previous year, but they did not make a loss. Living wood is charging £25 per sofa, but their costs per sofa are £28 i. e. £3 more per sofa. This means that for every sofa they manufacture, Living wood will invariably

make a loss of £3. With this loss Living wood cannot pay its fixed costs, and isn't even able to break even.

If operations continue in this manner, in the long-run, the business will be forced to shut down. To improve the financial status, the company would either have to increase their selling price, or reduce their total average costs. But, if they increase the selling price, the customers may not be as willing to buy their products, resulting in a decrease in sales. This will not be good for Living wood since they are not that good to begin with. By reducing the average costs, Living wood will be able to sustain their customers, and even make a profit. To decrease their costs, Living wood could make an agreement with their workers to improve efficiency and reduce or stop wastage. They could perhaps buy cheaper raw materials, thereby cutting down on the raw material expenses. But with this, they may have to make lower quality sofas. In the case, they show that Living wood bought new machinery for £2000. Usually, when new machinery is bought, efficiency improves, and labour costs are reduced.

However, here the labour costs have increased for every month after the purchase of the new machinery by £600, which is nearly a 50% increase. This goes to show that either, the machinery is not effective for production or extra labour is hired to operate the machinery, which is costing Living wood more than they can afford. While looking at the cash budget, we can see that Living wood is not managing their cash flows efficiently. Living wood is allotting a 2 month credit period to its customers. With the information we have, it is seen that they cannot really afford to do this. So, by reducing the

credit period Living wood will be able to improve their cash flow. They could even ask for an extended credit period from their suppliers therefore improving their cash flow further. Conclusion

Living Wood Ltd is a private limited company that was set up by three carpenters, Billi kid, Bengazy and Lee Jones. It is a medium-sized company that produces furniture for the retail sector and private homes, and is mainly in the domestic market. Living Wood is a business with good potential and resources available. However, they are not currently making the best of these resources, and therefore are falling into losses. After preparing the cash budget I found that Living Wood is losing money with every unit they produce, as their production cost is £3 more than their selling price. Another issue I noticed was that the machinery they bought only added to the average costs, therefore being able to conclude that the machine was ineffective in helping Living Wood produce more efficiently.

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