Importance of financial structure and statements

Business, Accounting

Introduction

This essay discusses the role of financial structures on the profitability and stability of companies and the role of financial statements prepared using historical cost convention and accruals concept in the decision making process. Both aspects of companies discussed here are of much importance as they directly affect companies, their financial condition and the representation of facts to the relevant users. The financial structure of a company reflects various sources the company has used tofinanceits operations. The financial statements provide vital information to users such as shareholders, managers, banks, tax authorities and research analysts to make important decisions.

Financial Structure

The financial structure of a firm is the way the assets and operations are financed. A company employs various modes of financing to acquire assets and support its operations. The financial structure includes components such as short term liabilities, long term debt and shareholders’ equity. Financial structure is different from capital structure as the capital structure only includes long term debt and shareholders’ equity and ignores short term liabilities. More successful companies focus more on financial structure rather than capital structure as the analysis of financial structure reveals both the short term and long term aspects of the company in terms of profitability and stability, whereas capital structures focus mainly on long term stability of the company.

Short term liabilities include but are not limited to accounts payables, accrued liabilities and short term loans. The financial structure is affected by various elements such as market competition, utilization of assets, behavior and decisions of managers and the level of sales. The existence and stability of companies depends on profitability as it would be illogical to operate a company for an extended period without making any profit. The profitability of a company is dependent on the financial structure as a company would not be able to operate without finances and it would have nothing to offer or sell to its customers.

Profitability and Value Creation

The objective of company management is the creation of value for shareholders. This value can be created through various methods but the most important component of value is the actual ability of the company to generate profits. The effect and role of financial structures on the profitability of the firm is quite significant. Successful companies continuously strive to increase the profitability of the company as higher profitability means higher value for the firm and eventually the shareholders.

The profitability is dependent on many factors including financial structure, sales volume and cost structure. The compensation of managers in many companies is linked with their ability to surpass budgeted sales and profits levels. The value of a firm for shareholders is measured through various tools including Economic Value Added and Market Value Added and Return on Invested Capital.

Importance of Financial Structure

Financial structure of a company is important for the management and shareholders as it defines the various modes of financing the company uses to support its operations. The two main components of a financial structure; short term and long term components, help in identifying two different aspects of a business. The liquidity ratios of a business indicate the ability of a firm to meet short term obligations. These ratios depend on the short term borrowings or liabilities of the company. The liquidity ratios also indicate the current stability of the firm. The level of working capital of a company also affects the profitability of a company.

The optimum level of working capital is the point where working capital requirements maximize the profitability of the firm. The level of working capital is dependent on the level of current assets and current liabilities. The three major current assets and liabilities other than cash which affect the level of profitability are accounts receivable, accounts payable and inventories. The cash conversion cycle depends on these three components and this cycle can be amended by changing the levels of current liabilities to maximize the returns of the company. Managers of many companies try to attain a level of cash conversion cycle where maximum profit is attained.

Many companies use accounts payable as a short term financing tool although the cost of using it is quite high but it directly affects the level of working capital and cash conversion cycle. The cash conversion cycle denotes the time period between collection of receivables and payment of payables. At an optimum level the cash is collected early on receivables and payment is deferred on payables which frees up a considerable amount of cash which can be reinvested in the business to maximize profitability. Credit

and finance managers are continuously involved in evaluating this optimum level of cash conversion cycle and working capital to increase the growth rate and returns of the company.

Companies with high growth potentials and high profitability use accounts payables as a means to increase working capital efficiency and cash cycle (Lazaridis & Tryfonidis, 2007). The other important component of the financial structure is the long term component which also makes up the capital structure of a firm. The capital structure which is different than the financial structure includes long term debt and shareholders' equity. The profitability of a firm is highly dependent on the capital structure. The firms with stable sale revenues can incorporate debt to their capital structure and can use this debt to match the increasing demand.

Companies with high rates of return usually do not use high levels of debt financing as the higher rate of return makes internal sources of funds more feasible (Brigham & Ehrhardt, 2001). The reliance of a company on equity or debt increases or decreases the rate of Return On Investment. The value of a firm to shareholders is also dependent on the capital structure as the use of debt for financing can cause the value of Earnings Before Interest and Taxes – EBIT to decrease or increase. The financial leverage also plays a very important role in the capital structure. The more debt company uses in the capital structure the higher is the interest expense for the company which means a lower amount of distributable profit to the shareholders.

If the capital structure consists of a larger portion of equity and the weight of debt is very low, the shareholders are exposed to a larger part of the business risk. An optimal capital structure not only contributes to the

profitability of a firm, the required rate of return also increases for the shareholders. The important aspect to consider in the capital structure is the relative cost of equity and debt. The cost of debt for any company is quite low than that of equity, so the managers may choose to finance more through debt, but too much reliance on debt would result in an increase in interest expenses and lower distributable profits.

The long term stability of a firm is also very closely linked to the capital structure as it depends on the eventual wealth maximization of shareholders. In order to maximize shareholders wealth the managers of a company have to select an optimal capital structure which entails the estimation of interest payments, cost of equity, weighted average cost of capital, discounted free cash flows for value of the firm and deducting the amount of debt from these cash flows to arrive at the amount of shareholders' wealth (Rao, 1989).

The growth rate of a company is also very closely linked to the capital structure, companies with higher growth rates rely more on debt due to the lower cost of debt in order to achieve higher returns but the long term stability would be affected immensely due to greater reliance on debt. Further understanding of debt and equity relationship can be achieved from the following illustration.

Suppose ABC Inc. has two options of using debt and equity in different scenarios. EBIT of the company is assumed to be $500, 000. The capital requirement for the company is $10 million; the interest rate and tax rate is 7% and 40% respectively. The cost of debt after tax is 5% whereas the cost

of equity is 8%. The effects of two different scenarios of financing through debt and equity are illustrated.

Scenario 1		Scenario 2	
30% debt and 70% Equity		70% debt and 30% Equity	
Weight of Debt	30%	Weight of Debt	70%
Weight of Equity	70%	Weight of Equity	30%
Cost of Debt	5%	Cost of Debt	5%
Cost of Equity	8%	Cost of Equity	8%
Interest Rate	7%	Interest Rate	7%
Tax Rate	40%	Tax Rate	40%
	$		$
Capital Requirement	10, 000, 000	Capital Requirement	10, 000, 000
Debt	3, 000, 000	Debt	7, 000, 000
Equity	7, 000, 000	Equity	3, 000,

			000
EBIT	500, 000	EBIT	500, 000
Less: Interest Expense	(210, 000)	Less: Interest Expense	(490, 000)
EBT	290, 000	EBT	10, 000
Less: Tax	(116, 000)	Less: Tax	(4, 000)
EAT	174, 000	EAT	6, 000
WACC	7. 1%	WACC	5. 9%

Scenario 1 of the illustration entails 30% reliance on debt and 70% on equity, whereas scenario 2 entails 70% reliance on debt and 30% on equity. The WACC of scenario 1 is 7. 1% as the component of equity is higher in this case and the Earning After Tax which is distributable to shareholders is $174, 000 while in scenario 2 the WACC has dropped to 5. 9% but it has also decreased the value of EAT which is now $6, 000. Although the cost of capital has decreased in scenario 2 the amount distributable to shareholders has also dropped. This shows that a greater reliance on debt would in fact decrease the cost of capital but it would also reduce profit for shareholders.

Financial Statements

Accountants prepare financial statements to be used by management, shareholders, creditors, customers, banks and government for various

decision making purposes. As the decisions made by these parties are very crucial, the information these decisions are based on should be reliable and relevant for each user. The International Accounting Standards Board – IASB provides a guideline to accountants for preparing financial statements to present information that is relevant and reliable to all these users and specially shareholders.

The financial statements used for decision making and stewardship purposes are usually the income statement, balance sheet and statement of cash flows. The IASB provides various concepts, assumptions, principles and measurement standards for various elements of financial statements through the International Financial Reporting Standards – IFRS. The preparation of financial statements under the historical cost convention and accrual concept of accounting is discussed here. If both of these concepts are not applied by accountants in preparing financial statements, there can be a significant variation in the balances of different items reported on the financial statements.

Historical Cost Convention

Historical cost is the cost originally incurred for the purchase of an asset or any other transaction. The historical cost does not include any adjustments for inflation or current changes in price. Historical cost helps accountants and users of financial statements to distinguish between the current or market cost and the cost originally incurred to purchase an asset.

The historical cost convention explains to an accountant that all assets should be presented on the balance sheet according to the historical

purchase price including all the capital expenditures incurred for acquiring it (Meigs, Williams, Bettner, & Haka, 2002). As an example suppose a company purchased an equipment worth $50, 000 in 2003, the 2009 balance sheet reports the cost of the asset at this same amount of $50, 000 instead of its replacement cost or market price which could be higher or lower than the original cost.

Accrual Basis of Accounting

The cash basis of accounting includes the presentation and recording of transactions when cash is paid or received whereas in the accrual basis of accounting the expenses are recorded as and when they are incurred irrelevant of the timing of cash payment and revenues are recorded as and when they are earned irrelevant of the timing of cash receipt. This reflects all the revenues earned and expenses incurred on the income statement irrelevant of the cash flows. The accrual basis of accounting also enables the matching of revenue and expenses in a specific period of time. For example a company manufactures products and delivers the same to its customer but the customer will pay the amount due on these products 1 month later in the next year.

At the end of the year this revenue will be recorded as accrued revenue even though the amount has not been received from the customer yet. If the company has used utilities like electricity or telephone in a given year and the amount outstanding on the bills will not be paid until the next year, the outstanding amount will be booked as an expense in the income statement of the current fiscal year as accrued expenses. It should also be noted that the accrued revenue and expenses are also reflected on the balance sheet.

The accrued revenues are presented as receivables and accrued expenses are treated as liabilities on the balance sheet (Sangster & Wood, 2007).

Financial Statements Prepared under Historical Cost and Accrual Concepts

The information contained in the financial statements is vital not only for external users such as shareholders, creditors, banks and government it is quite important for the internal users such as the management of the company as well. The management of the company uses this information to make financial and economic decisions about relevant to the future stability of the company. These decisions may include fixing prices, manufacturing of new products and modes of financing.

The external users make decisions based on the information about lending, investing and selling to the company. The information contained in the financial statements should be reliable and relevant. This means that the information should reflect a true reflection of the company's past and should be relevant to make economic decisions about the future (Ireland, 2005). The financial statements prepared under the accrual basis of accounting report an accurate amount of net income or net loss during a specific period but under the cash system this amount would not be accurate.

In order for the information reported in the financial statements to be relevant for stewardship and decision making purposes, the financial statements should be prepared using the accrual basis of accounting. The historical cost concept presents the actual cost of assets which is more reliable and relevant as the market or replacement value keeps fluctuating and the necessary adjustments required would have to be implemented each

time to make the amount reliable. Recording the assets on historical costs renders the balance sheet more transparent and reliable for both the internal and external users.

The historical cost concept is simple and does not need any referencing to market prices and the fluctuations related to the market. The values of assets recorded under the historical cost concept are most common and can be understood easily by people. When a company uses the historical cost concept for reporting assets it does not need to record any gain or loss of revaluation until the gain or loss is realized. Although the accrual basis of accounting is sometimes difficult for some people to understand but the financial statements prepared under this system measure profit and loss more accurately than the cash system.

The financial position of a firm is more accurately presented and is realistic for users who base their decisions on these statements. This accurate information can also be used to accurately approximate the future financial position and growth of the company.

Conclusion

After the analysis of two different scenarios and the evaluation of current and long term components of the financial structure it can be concluded that the profitability and future stability of the firm is very much dependent on its financial and capital structure. The management of the company tries to achieve an optimal financial structure to increase the value and worth for shareholders. It can be concluded from the second part of this paper that the financial statements prepared under the historical cost concept and using

the accrual basis of accounting provide both internal and external users with more relevant and reliable information in making proper decisions about the future.

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