Example of research paper on understanding finance concepts

Business, Company

Understanding Financial Concepts

Financial ratios are vital for both small and large businesses. Some people feel that small business should not monitor the financial ratios for their business, but it is reasonable to understand their importance to the owner. Investments usually involve various levels of risk, and it is crucial to understand those risks and how to diversify. Financial ratios, debt financing, risks, and financial returns are excellent key concepts to use in business, but do not come without any issues or concerns.

Therefore, there are three financial ratios that are crucial for small businesses; debt-asset, quick, and receivable ratios. As an owner of a small business called a JHL enterprise that deals in importing and exporting clothes and shoes, I would monitor the days of receivables, the Debt-to-Assets ratios, and the quick ratios. For the days of receivables, I would compare the average number of revenue to the total receivables. If the days increase, it would mean that more of the business finances are tied up in accounts receivables, meaning that the cash is not enough to pay bills and workers. I would also use the Debt-to-Assets ratio to find the ratio of assets to the liabilities in the business. If the ratio is small, it would mean that the business has reduced assets or more debts, showing that the debt is currently supporting the business. The other financial ratio that I would use would be the quick ratio to show the ratio of current assets to the current liabilities. This would be effective in giving me a picture of the extent to which the business is getting into debts; hence ease in which it can finance its operations.

For a manager of a large company, there are other ratios that are vital for

the running of the business. For example, a large business has to be concerned with the Dividend policy ratios used for making decisions about the portfolio and investments (Knežević, 2011). The dividend policy ratios can be in the form of dividend yield and payout ratio. Also, the manager would be concerned with activity ratios in order to measure various financial activities such as collecting debts, selling inventories and managing resources (employees and equipment). This is because large businesses have many employees and equipment such that there has to be a way of monitoring and managing them and other related activities. However, debt financing is the act of borrowing some finances to support a business and agreeing upon the interest with the lender. Debt financing has several advantages and disadvantages. One of the main advantages is that it enables the owner to retain control of the company. Also, various entrepreneurs are able to take part in decision making while giving small business owners with much financial freedom. The other advantage that is associated with debt financing is that debt obligations are confined only during loan repayment period. This means that the lender has no right to claim in the future after the repayment. Debt financing is also easily managed and administered due to lack of difficult reporting requirements, and it is also relatively inexpensive for long term purposes.

However, debt financing is disadvantageous because every debt requires repayment regardless of occurrences of profits or losses. Also, the company may reach a break-even- point due to the fixed interests that are administered. When faced with options, a company prefers to use stocks than bonds to create revenue, because stocks would increase the business'

capital, while bonds would mean that the business is borrowing money from other sources and that money must be returned with interest. According to Kaya, (2011), bonds are riskier because if a company goes bankrupt, the bonds can eventually lose value, and if interest rates go up, one may end up with low returns on the bonds in the long run.

Before making financial decisions, it is vital to consider all issues related to risks and returns, and how those two depend on each other. From the definition, risk refers to the probability that the financial return on an investment will vary from the expected return. It is believed that an investment that consists of a high risk tends to have the potential of realizing high returns. In most cases, zero-risk investments usually yield low returns (for, example the Treasury Security) while high risk investments can yield extremely high returns (for example, startup stock) (Shomir, 2011).

In issues dealing with securities markets, there are many factors that drive financial

transactions, decision making and risk analysis. Beta refers to the measure of price volatility of a stock as compared to the rest of the market. The number is usually given as a beta of 1 for the proxy of S&P 500 for the whole market (Charitou, 2011). Any stocks assigned a number greater than Beta 1 can be considered risky to buy because of the increased price volatility. For the stocks assigned Beta1, they are noted to have the same price value as the overall market, while those with less than Beta1 are considered to be less risky. Because of the relationship between risk and returns on investments, any stocks that have a high Beta are usually expected to have high returns on investments. Betas can also be used to compare a

company’s stock with its peers.

Assets are usually faced with different types of risks namely systematic and unsystematic risks. These are risks that have to be considered when making important financial decisions. Unsystematic risk refers to diversifiable risk that shows the part of an asset that result from random causes such as strikes or regulatory actions. It could result from pricing, marketing strategy, labor unions or research and development. Systematic risk refers to non-diversifiable risk associated with an asset, resulting from market factors such as political crisis, war and inflation. It is called non diversifiable risk because it cannot be eliminated through diversification (Giannetti, 2010). A combination of the two types of risks is known as total risk.

Now that my corporation has won our patent law suit, we need to develop a financial plan for my million dollar earnings. I would consider the time value of money when making that decision because the same amount of money can earn interest over time according to finance theory. This would include a comparison between the present and future value of the lump sum at hand. After comparing the present and future value of the $1million, I would consider receiving the whole amount as soon as possible, and I would not entertain any late payments. A plan to invest a large sum of cash needs planning, so as to ensure the corporation diversifies the risk and receives a fair return (Giannetti, 2010). I would diversify the risk by investing in different areas instead of buying just one stock. This is because if the cash is invested in a single stock, the risk becomes great, considering that anything negative may happen. If the money is used to buy a wide range of stocks in a diversified portfolio, the risk is minimized. A diversified portfolio may

consist of stocks in proportions of 20, 50 or 100, so as to ensure that nearly all unsystematic risks are eliminated. Diversification ensures that the risk is minimized, and the expected returns remain high.

In conclusion, starting an enterprise requires sound financial knowledge. There are many financial decisions when starting a small business, the decision you make can either make or break you. A successful business requires understanding in crucial components of securities markets such as financial ratios, debt financing, risks, and financial returns in both small and large businesses, and how markets determine business decisions, analysis of risks, and fiscal transactions. Furthermore, one needs to understand the concepts of time value of money, present and future value and how it influences financial decisions.

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