

# Understanding the concepts report examples

[Business](#), [Company](#)



## **Financial management**

In large organizations, ratios are usually used for benchmarking as well as for effectively analyzing the performance. Both large and small organizations are usually interested in the profitability, efficiency and the liquidity of their firms. Profitability ratios measure the rate at which organizations are successful in creating wealth. Efficiency ratios measure the capability of organizations in utilizing the company's resources in earning profits. The liquidity ratios measure the ability of organizations in meeting the short term obligations.

### **Profitability ratio**

The profitability ratio is usually composed of return to asset ratio, net profit margin and gross margin ratio. A small firm would be interested in these ratios under profitability since they provide precise information regarding the profitability of the company. For instance, the return to asset ratio shows the profitability in relation to its assets. A high ratio indicates that the firm is prudently utilizing the assets of the firm. Therefore, this ratio would be important to a manager as it indicates the areas to be improved in case a company or a firm is under performing. The net profit margin indicates the performance of a company before meeting the financial obligations incurred by the company. A low net profit margin shows that the company sales are not adequate for meeting the company's expenses. Therefore, this ratio would be important to a small firm since it gives an average of sales required in order to meet the company expenses.

## **Efficiency Ratios**

The ratios of interest to a manager under efficiency ratios would be the debtor's turnover, stock inventory turnover and asset turnover ratio. The debtor's turnover helps the manager evaluate how long the company's funds stay with the debtors. The stock inventory turnover indicates how fast or slow the stock is moving, and therefore; the management is able to reduce inferior or obsolete stocks. The asset turnover shows the overall performance the business and its activities level. Therefore, a low asset turnover ratio shows that an organization is not prudently utilizing its resources hence a need for improvement.

## **Liquidity ratios**

Liquidity in an organization is an important factor for consideration. The liquidity is usually measured by two main ratios which are current ratio and quick asset ratio. High liquidity ratios indicate that the company can be able to meet its short term obligations when they fall due. Therefore, a small firm should be interested in the liquidity ratios so that it can be able to have a good picture as to whether it can be able to meet its short term obligations.

## **Advantages of debt financing**

Maintain ownership

When a company uses debt finance, the only obligation that the company has is that of paying the agreed-upon payments. Therefore, the investors maintain ownership without worrying of dilution of control due to debt financing.

## **Tax deductions:**

Debt financing attracts huge tax deductions since most interest and principal payments are usually classified as business expenses hence deducted as income taxes. This reduces the amount of tax liability incurred by the company making debt financing a cheaper source compared to other alternatives.

## **Lower interest rate**

When companies borrow debt, the government allows a tax advantage on the rate of borrowing by the rate of corporate tax prevailing. This reduces the rate of interest that a company uses for paying interest payments making debt financing very cheap.

## **Drawbacks to Debt Financing**

### **Repayment**

A company that uses debt financing is obligated to pay interest every year irrespective of whether it makes a profit or not. Failure to meet the obligations forces an organization into insolvency which distorts the business activities.

### **High rates**

Sometimes financing organizations offer credit at high rates, and this assimilates most of the company's retained earnings.

### **Impacts on credit rating**

Debt financing is sometimes very cheap hence enticing managers to borrow more, and this leads to high gearing of the firm which reduces the stock

rating in the stock market hence reducing the value of stocks as perceived by investors in the stock exchange market.

### **Why managers do not like equity financing**

Equity financing involves flotation costs which are mostly expensive on the side of the company. The issue costs are usually met by the company and the larger the number of ordinary shareholders, the higher the cost. In addition, an organization does not prefer equity financing since it dilutes the ownership of the current shareholders and most shareholders do not prefer this.

### **How financial returns are related to risk**

Risk in relation to returns refers to the degree of uncertainty. Generally, studies show that investments with least uncertainty have lower returns while investments with more uncertainty are perceived to have high returns. The perceived relationship leads to the risk/return trade off. The risk/ return tradeoff refer to the balance between the desire for the highest possible return and lowest possible risk. According to the risk/return tradeoff, a high standard deviation in a portfolio implies high possible returns.

However, there are some investments that do not have any risk attached to them. The investments usually have a risk-free rate of return which implies that there are no chances of defaulting as there is no risk. Investments in the U. S Government Securities usually have a risk free rate of return, and it implies that the chance of defaulting is zero since risk does not exist.

## **Concept of beta and how it is used**

### **Beta**

Beta is a ratio that measures the volatility of stocks in relation to the market. Generally, the beta of the market is usually one, and this provides the basis against which stocks are ranked depending on the deviation from the market.

The beta coefficient of any security takes a range of two values. If the beta falls below one, it means that a stock has a lower systematic risk than that of the market. Therefore, when the stock has a lesser beta than that of the market, the beta is referred to as defensive since an increase in the market risk will have less impact on the stock returns. On the other hand, when the beta coefficient of a stock is above one, it implies that the security is very sensitive to increases in the market risk hence referred to as aggressive. Beta is used in the Capital Asset Pricing Model (CAPM), which is mostly used for calculating the cost of capital. Therefore, if a company has a high beta, it implies that the cost of capital in relation to the company will be high and vice versa. Beta is an instrumental tool in company's share valuation.

### **Contrast systematic and unsystematic risk.**

Systematic risk also refers to non-diversifiable risk, which is the risk that is usually attributed to the market forces and it is usually beyond the control of the firm. This type of risk cannot be eliminated through diversification.

Systematic risk is usually caused by factors such as international incidents, war, political events and inflation.

Unsystematic risk is also referred to as diversifiable risk. This risk is usually

associated with firm's specific events such as lawsuits, strikes, regulatory actions and loss of a key account. This type of risk occurs due to factors specific to a company or an industry like pricing, research and development, labor unions and marketing strategies among others specific to a firm and can be eliminated by diversification.

### **How \$1 can be invested in order to receive a good return and diversify the risk**

When deciding on the type of investment to invest in, it is important to consider the risk attached and the possibility of diversification in order to receive a good return. The plan would be to invest in different portfolios so as to ensure that the risk is diversified. I would use \$250, 000 to expand the manufacturing business and ensure that all the unsystematic risk is eliminated. Since the unsystematic risk involves factors specific to a firm, the investment will ensure all the risk is eliminated. \$250, 000 would be invested in a Government security which will earn the company fixed returns that a risk less every year. The government securities offer a risk free rate of return and, therefore; the company will have no worry of defaulting. The other \$250, 000 would be invested in shares of a company that has a potential of growth, and this will be considered as the long term investments. Finally, the remaining \$250, 000 would be invested in debentures which will represent the company's short term investments.

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