Chapter 14
MANAGING THE FINANCE FUNCTION

What the Finance Function Is

- The finance function is an important management responsibility that is concerned with the procurement and administration of funds with the view of achieving the objectives of business.

The Determination of Fund Requirements

- Business firms will need funds for the following specific requirements:
  1. to finance daily operations;
  2. to finance the firm's credit services;
  3. to finance the purchase of inventory; and
  4. to finance the purchase of major assets.

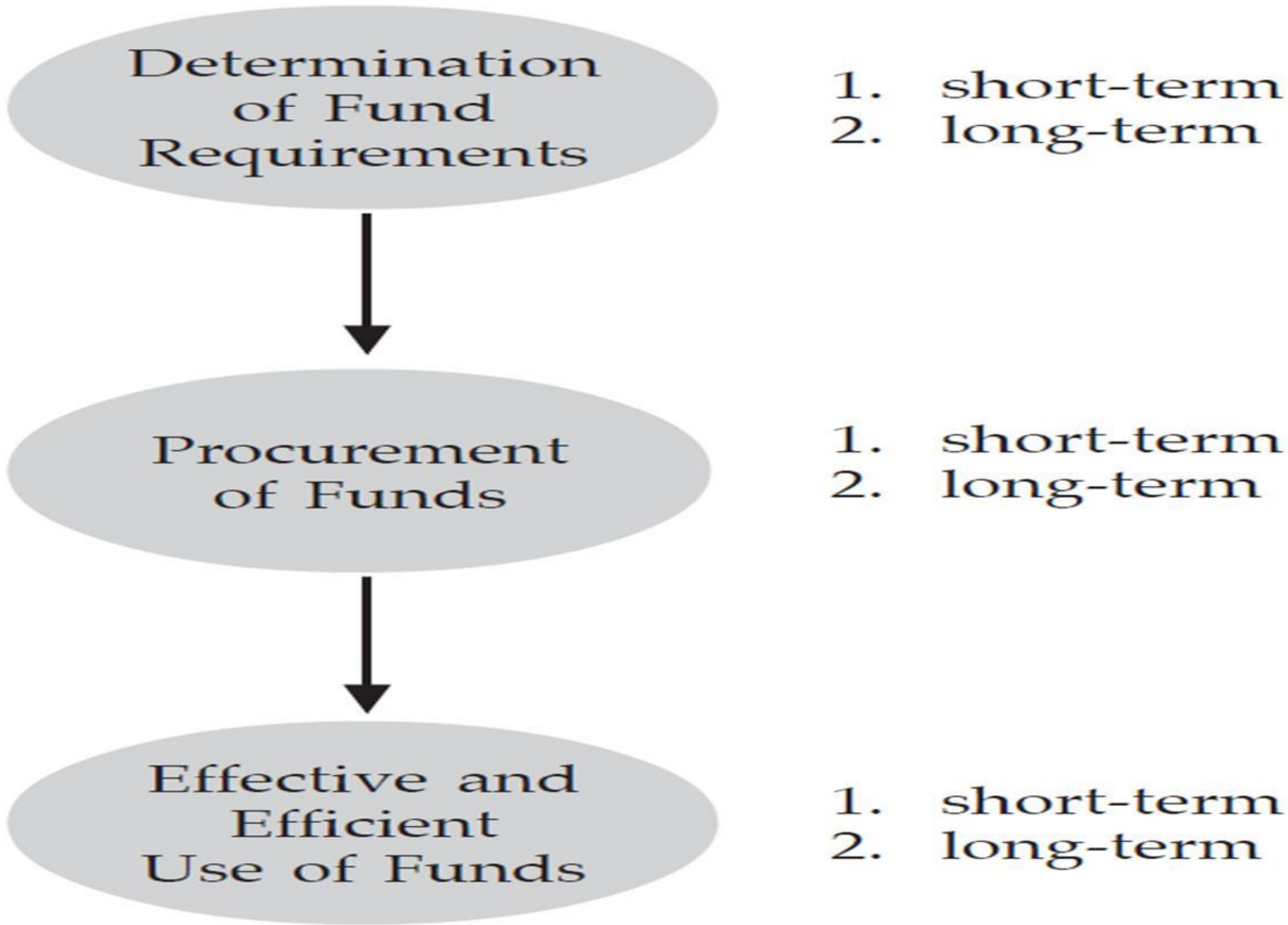

Figure 76. The Finance Function: A Process Flow

Financing Daily Operations

- The day-to-day operations of the firm will require funds to take care of expenses as they come.

- Money must be available for the payment of the following:
    1. wages and salaries
    2. rent
    3. taxes

4. power and light
5. marketing expenses like those for advertising, entertainment, travel, telephone, stationery and printing, postage, and others
6. administrative expenses like those for auditing, legal services, consultancy services, and others

Financing the Firm's Credit Services

- The extension of credit to customers is, oftentimes, unavoidable.
- The sales terms of manufacturing firms vary from cash to 90- day credit.

Financing the Purchase of Inventory

- The maintenance of adequate inventory is crucial to many firms.
- Raw materials, supplies, and parts are needed to be kept in storage so they will be available when needed.

Financing the Purchase of Major Assets

- Companies, at times, need to purchase major assets.
- When top management decides on expansion, there will be a need to make investments in capital assets like land, plant, and equipment.

Sources of Funds

- To finance its various activities, the business firm will have to make use of its cash inflows consisting of the following:

1. Cash sales	Cash flows into the coffers of the firm when it is able to sell its products or services.
2. Collection of accounts receivables	Some business firms extend credit to customers. When these are settled by the customers, cash is made available to the firm.
3. Loans and credits	When other sources of financing are not enough, the firm will have to resort to borrowing and cash is made available to the firm.

4. Sale of assets	Cash is sometimes obtained from the sale of the company's assets. First to be sold are the company's idle assets.
5. Ownership contribution	When cash is not enough, the firm may tap its owners to invest more money.
6. Advances from customers	Sometimes, customers are required to pay cash advances on orders made. This helps the firm in financing its production activities.

Short-Term Sources of Funds

- Short-term sources of funds are those with repayment schedules of less than one year.
- Collaterals are sometimes required by short-term creditors.

Advantages of Short-Term Credits

1. They are easier to obtain.
2. Short term financing is often less costly.
3. Short-term financing offers flexibility to the borrower.

Disadvantages of Short-Term Credits

1. Short-term credits mature more frequently.
2. Short-term debts may, at times, be more costly than long-term debts.

Suppliers of Short-Term Funds

1. trade creditors;
2. commercial banks;
3. commercial paper houses;
4. finance companies;
5. factors; and
6. insurance companies.

- *Trade creditors* are those suppliers extending credit to buyers engaged in manufacturing, processing, or reselling goods for profit.

- The instruments used in trade credit consist of the following:
  (1) open book credit;
  (2) trade acceptance; and
  (3) promissory notes.

- The *open-book credit* is unsecured and permits the customer to pay for goods delivered to him within a specified number of days.

- The *trade acceptance* is a time draft drawn by a seller upon a purchase payable to the seller as payee, and accepted by the purchaser as evidence that the goods shipped are satisfactory and that the price is due and payable.

- A *promissory note* is an unconditional promise in writing made by one person to another, signed by the maker, engaging to pay, on demand or at a fixed or determinable future time, a sum certain in money to, or to the order of, a specified person, or to bearer.

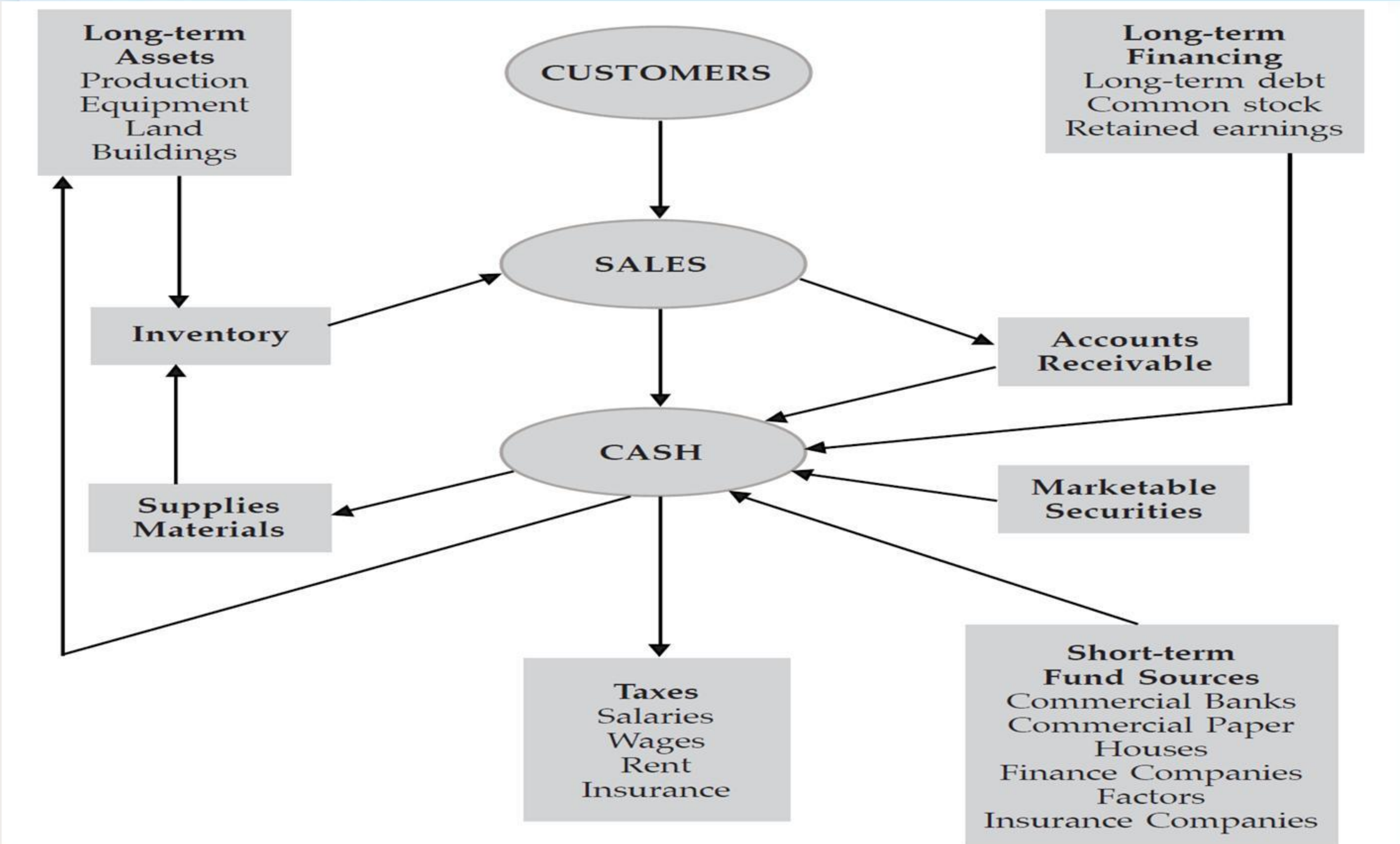

Figure 77. The Firm's Finances and Cash Flow

- *Commercial banks* are institutions which may be tapped as sources of short-term financing by individuals or firms.

- Two types of short term loans are made available by commercial banks:
  (1) those which require collateral; and
  (2) those which do not require collateral.

- *Commercial paper houses* are those that assist business firms in borrowing funds from money market investors.

- *Business finance companies* are financial institutions involved in financing inventory and equipment of almost all types and sizes of business firms.

- *Factors* are institutions that buy the accounts receivables of firms, assuming complete accounting and collection responsibilities.
- *Insurance companies* are also possible sources of short-term funds. Industry reports indicate that insurance companies in the Philippines regularly make investments in short-term commercial papers and promissory notes.

Long-Term Sources of Funds

- Long-term sources of funds are classified as follows:
    1. long-term debts;
    2. common stocks; and
    3. retained earnings.

- Long-term debts are sub-classified into *term loans* and *bonds*.

Term Loans

- A term loan is a commercial or industrial loan from a commercial bank, commonly used for plant and equipment purchase, working capital, or debt repayment.

- Term loans have maturities of between 2 to 30 years.

- The advantage of term loans as a long-term source of funds are as follows:
    1. Funds can be generated more quickly than other long-term sources.
    2. They are flexible, i.e., they can be easily tailored to the needs of the borrower.
    3. The cost of issuance is low, compared to other long-term sources.

Bonds

- A bond is a certificate of indebtedness issued by a corporation to a lender.
- It is a marketable security that the firm sells to raise funds.

TYPE OF BOND	FEATURE
1. Debentures	No collateral requirement
2. Mortgage bond	Secured by real estate
3. Collateral trust bond	Secured by stocks and bond owned by the issuing corporation
4. Guaranteed bond	Payment of interest or principal is guaranteed by one or more individuals or corporations
5. Subordinated debentures	With an inferior claim over other debts
6. Convertible bonds	Convertible into shares of common stocks
7. Bonds with warrants	Warrants are options which permit the holder to buy stock of the issuing company at a stated price.
8. Income bonds	Pays interest only when earned

Figure 78. Types of Bonds

Common Stocks

- The third source of long-term funds comes with the issuance of common stocks. Since common stocks represent ownership of corporations, many investors are placing their money in them.

Retained Earnings

- Corporate earnings not paid out as dividends are referred to as retained earnings.

The Best Source of Financing

- In determining the best source of financing, the following factors must be considered:
  1. flexibility;
  2. risk;
  3. income;
  4. control;
  5. timing; and
  6. other factors like collateral values, flotation costs, speed, and exposure.

Flexibility

- Some fund sources impose certain restrictions on the activities of the borrowers.
- As some fund sources are less restrictive, the flexibility factor must be considered.

Risk

- Risk refers to the chance that the company will be affected adversely when a particular source of financing is chosen.

- Generally, short-term debt subjects the borrowing firm to more risk than does financing with long-term debt.

- This happens because of two reasons:

  1. Short-term debts may not be renewed with the same terms as the previous one, if they can be renewed at all.
  2. Since repayments are done more often, the risk of defaulting is greater.

Income

- The various sources of funds, when availed of, will have their own individual effects in the net income of the business firm.

Control

- When new owners are taken in because of the need for additional capital, the current group of owners may lose control of the firm’s management.

Timing

- The financial market has its ups and downs. This means that there are times when certain means of financing provide better benefits than at other times.

Other Factors

- There are other factors considered in determining the best source of financing.

- They are the following:

  1. Collateral values
  2. Flotation costs
  3. Speed
  4. Exposure

The Firm's Financial Health

In general, the objectives of business firms are as follows:

1. To make profits for the owners;
2. To satisfy creditors with the repayment of loans with interest; and
3. To maintain the viability of the firm so that customers will be assured of a continuous supply of products or services, employees will be assured of employment, suppliers will be assured of a market, and others.

Indicators of Financial Health

- The financial health of a company may be determined with the use of three basic financial statements. These are the following:
  1. The balance sheet – also called statement of financial position;
  2. The income statement – also called the statement of operations; and
  3. The statement of changes in financial position.

Risk Management and Insurance

- The manager, specially the one at the top level, is entrusted with the function of making profits for the company. This will happen if losses brought by improper management of risks are avoided.

Risk Defined

- *Risk* refers to the uncertainty concerning loss or injury. The business firm is faced with a long list of exposure to risks, some of which are as follows:
    1. fire;
    2. theft;
    3. floods;
    4. accidents;
    5. nonpayments of bills by customers (bad debts);
    6. disability and death; and
    7. damage claim from other parties.

Types of Risk

- Risks may be classified as either pure or speculative.
- *Pure risk* is one in which there is only a chance of loss. This means that there is no way of making gains with pure risks.
- *Speculative risk* is one in which there is a chance of either loss or gain. This type of risk is not insurable.

What is Risk Management

- *Risk management* is an organized strategy for protecting and conserving assets and people.

- The purpose of risk management is to choose intelligently from among all the available methods of dealing with risk in order to secure the economic survival of the firm.

Methods of Dealing with Risk

- There are various methods of dealing with risks. These are the following:

    1. the risk may be avoided;
    2. the risk may be retained;
    3. the hazard may be reduced;
    4. the losses may be reduced; and
    5. the risk may be shifted.

- A person who wants to avoid the risk of losing property like his house can do so by simply avoiding the ownership of one.

- There are instances, however, when ownership cannot be avoided like when it is really needed, for instance, equipment, appliances, and materials used in the production process. In that case, other methods of handling risk must be considered.

- Risk retention is a method of handling risk wherein the management assumes the risk. The planned risk retention, also called *self-insurance*, is a conscious and deliberate assumption of a recognized risk. In such case, management decides to pay losses out of currently available funds.

- Hazards may be reduced by simply instituting appropriate measures in a variety of business activities.

- Examples of efforts on loss reduction are as follows:
    1. physically separating buildings to minimize losses in case of fire;
    2. using fireproof materials on interior building construction;
    3. storing inventory in several locations to minimize losses in cases of fire and theft;
    4. maintaining duplicate records to reduce accounts receivable losses;

5. transporting goods in separate vehicles instead of concentrating high values on single shipments;
6. prohibiting key employees from traveling together; and
7. limiting legal liability by forming several separate corporations.

- *Hedging* refers to making commitments on both sides of a transaction so the risks offset each other.