CHAPTER 12

Financial management strategies

OVERVIEW

12.1 Introduction
12.2 Cash flow management
12.3 Working capital (liquidity) management
12.4 Profitability management
12.5 Global financial management

12.1 Introduction

There are a variety of strategies financial managers can implement to address issues of concern. Effective strategies businesses can use to address issues relating to cash flow, working capital, profitability and global financial management will be addressed in this chapter.

12.2 Cash flow management

BizWORD

Cash flow *is the movement of cash in and out of a business over a period of time.*

Cash flow is the movement of cash in and out of a business over a period of time. If more money goes out than comes in, or if money must be paid out before cash payments have been received, there is a cash flow problem. Matching cash flow in with cash flow out is essential.

By keeping records of cash flow, you know how much cash you have in your wallet or in the bank at a given time. However, this record does not tell you what debts you have or what is owed to you by others. The issue is the same for a business, which is why budgets are an important tool for managing cash flows. Examples of cash inflows and outflows are given in table 12.1.

TABLE 12.1 Some examples of a business's inflows and outflows of cash

Inflows	Outflows
Sales	Payments to suppliers — raw materials/ finished goods, etc.
Cash payment for accounts receivable	Interest on loans
Commissions received	Operating expenses — wages/salaries, raw materials/finished goods
Sales of assets	Drawings
Proceeds from issue of shares	Purchase of assets
Interest received (investments/ loans, etc.)	Loan repayments
Dividends received	

12.2.1 Cash flow statements

Cash flow statements are examined in detail in chapter 11, section 11.5.1. Remember though, the statement of cash flow indicates the movement of cash receipts and cash payments resulting from transactions over a period of time. It can also identify trends and can be a useful predictor of change.

12.2.2 Management strategies

A business may have temporary shortfalls of cash. Many businesses use overdrafts to cover these shortages. Banks allow the business to overdraw their account to a set limit with the payment of competitive interest rates. Shortfalls of cash over longer periods are of greater concern for a business as insolvency or bankruptcy may result.



FIGURE 12.1 The cash flow cycle describes how money flows through a business. Think of a business's cash balance like a bathtub. If you want the water in the tub to rise, you need to add more water and keep it from going down the drain. The more water that flows in and the less that flows out, the higher the level of water in the tub. Cash inflows and outflows work the same way.

The receipt of cash into a business does not necessarily coincide with payments of cash coming in. Management must implement strategies to ensure that cash is available to make payments when they are due — for example, to the Australian Taxation Office, suppliers for accounts payable, employees for wages, owners and shareholders for profits and dividends, banks and financial institutions for interest on loans or overdrafts, and leasing payments.

Distribution of payments

An important strategy involves distributing payments throughout the month, year or other period so that large expenses do not occur at the same time and cash shortfalls do not occur. Distributing payments throughout the year means there is a more equal cash outflow each month rather than large outflows in particular months. A cash flow projection can assist in identifying periods of potential shortfalls and surpluses.

Discounts for early payment

Another cash flow management strategy is offering debtors a discount for early payments. This strategy is most effective when targeted at those debtors who owe the largest amounts over the financial year period. This is not only beneficial for the debtors who are able to save money and therefore improve their cash flow, but it also positively affects the business's cash flow status.

Factoring

Factoring is the selling of accounts receivable for a discounted price to a finance or specialist factoring company. The business saves on the costs involved in following up on unpaid accounts and debt collection. Factoring is growing in popularity as a strategy to improve working capital. Factoring was examined in more detail in chapter 10, section 10.2.2.

BizFACT

The five most common reasons small and medium-sized enterprises (SMEs) experience cash flow problems are: slow paying debtors, rapid or unsustainable growth, failure to perform credit checks on debtors, tightened lending restrictions making it more difficult to get credit and seasonality (companies that make or sell seasonal goods often run out of funds during quieter times of the year).

BizFACT

Factoring has been an increasingly popular strategy used by Australian businesses to improve their liquidity. Figures released by the Debtor and Invoice Finance Association (DIFA) show that overall debtor finance (which includes both factoring and invoice discounting) totalled over $60 billion in 2015.

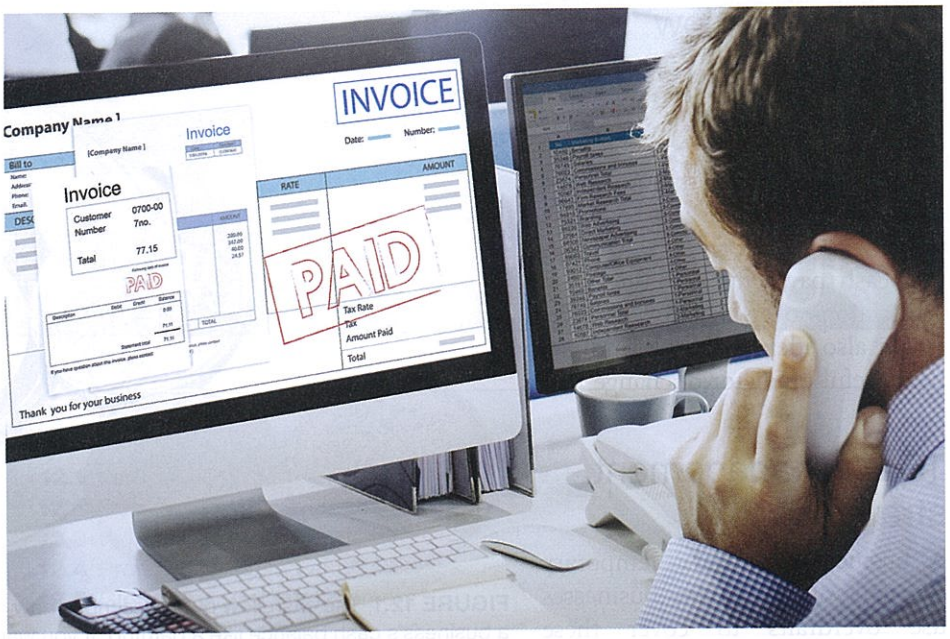


FIGURE 12.2 Invoice discounting, which is very similar to factoring, is a growing strategy used by businesses to manage cash flow. The difference between them is that with factoring the finance company is responsible for collecting the debts owed, whereas with invoice discounting the business chases their own payments in the usual way so that customers won't be aware of the arrangement.

studyON

Syllabus area 3
Topic 4
Concept 1

Cash flow management
Summary screen and practice questions

SUMMARY

- Cash flow is the movement of cash in and out of the business over a period of time. Management is required to make sure payments are made and received without creating a cash flow problem.
- A cash flow statement provides important information regarding a firm's ability to pay its debts on time.
- A cash flow statement can assist in identifying periods of potential shortfalls and surpluses.
- Management strategies for cash flow include:
  - distributing payments throughout the year so that cash shortfalls don't occur
  - using discounts for early payments
  - factoring.

EXERCISE 12.1 REVISION

1. **Define** the term 'cash flow'.
2. Choose a business you are familiar with and **identify** three cash inflows and three cash outflows for that business.
3. **Clarify** what information can be obtained from a cash flow statement.
4. **Demonstrate** why a cash flow statement is so important for a business.
5. **How** do the strategies of (a) distribution of payments and (b) discounts for early payment help improve cash flow?
6. **Recall** the purpose of factoring and **outline** how it influences cash flow.
7. Patane Motorcycle Tours runs both short and long trips throughout the year, although the warmer months, from September to April, generate the most revenue. Cash flow problems often arise in July as repairs are carried out on the bikes, and registration and insurances fall due. **Propose** ways for Patane Motorcycle Tours to manage their cash flow.
8. Judith runs a landscape gardening business and has come to you for financial advice. You find that she is reluctant to offer discounts for cash. **Explain** the reasons for and against offering discounts for cash and **recommend** some financial advice for Judith's business.

EXERCISE 12.1 EXTENSION

1 'Profit is not the same as cash in the bank.' **Analyse** this statement.

2 **Examine** cash flow statements from a number of businesses and **determine** the source of their cash flows. Comment on the management of cash flow for each business.

12.3 Working capital (liquidity) management

Short-term liquidity is important for businesses. It means a business can take advantage of profit opportunities when they arise, as well as meet short-term financial obligations, pay creditors on time to claim discounts, pay tax and meet payments on loans and overdrafts. A business must have sufficient liquidity so that cash is available or **current assets** can be converted to cash to pay debts. The lack of short-term liquidity could necessitate the sale of non-current assets, including long-term investments such as property and equipment, to raise cash. In the longer term, this can lead to reduced profitability for owners and shareholders.

Creditors place importance on a business's liquidity as they seek guarantees that their accounts will be paid. Failure to pay debts on time can alienate a business's creditors and suppliers who incur extra debt collection costs and lose confidence in the business.

Working capital is the term used in businesses to describe the funds available for the short-term financial commitments of a business. **Net working capital** is the difference between current assets and **current liabilities**. It represents those funds that are needed for the day-to-day operations of a business to produce profits and provide cash for short-term liquidity. The working capital cycle for businesses is illustrated in figure 12.3.

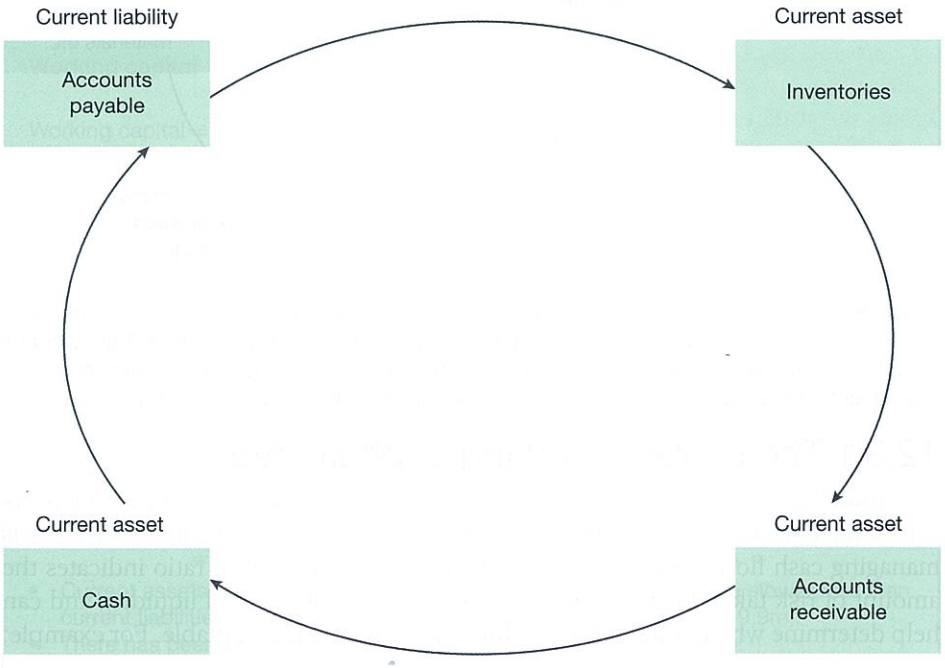


FIGURE 12.3 The working capital cycle. This refers to the length of time it takes a business to convert its net current assets and current liabilities into cash, that is, the time it takes from when a business purchases inventory to resell (or raw materials if they manufacture their products) to when they receive the cash once it's sold.

Through the operating cycle of a business, current assets are constantly changing as inventories are sold, cash is paid out and payments are received. Working capital is often the major asset of a business and current assets may make up approximately

BizWORD

Current assets *are assets that a business can expect to convert into cash within 12 months. They usually include cash and accounts receivable.*

BizWORD

Working capital *is the funds available for the short-term financial commitments of a business.*

Net working capital *is the difference between current assets and current liabilities. It represents those funds that are needed for the day-to-day operations of a business to produce profits and provide cash for short-term liquidity.*

Current liabilities *are liabilities that a business must repay within the short term. They usually include overdraft and accounts payable.*

40 per cent of a business's assets. Therefore, their use and management requires planning and constant monitoring.

Business failure can result from poor management of working capital. Insufficient working capital means there are cash shortages or liquidity problems and the situation forces businesses to increase their debt, find new sources of finance or sell off non-current assets. On the other hand, an excess of working capital means that assets are earning less than the cost to finance them.

BizWORD

Working capital management *is determining the best mix of current assets and current liabilities needed to achieve the objectives of the business.*

Working capital management involves determining the best mix of current assets and current liabilities needed to achieve the objectives of the business. Management must achieve a balance between using funds to create profits and holding sufficient funds to cover payments. The more efficient a business is in organising and using its working capital, the more effective and profitable it will be.

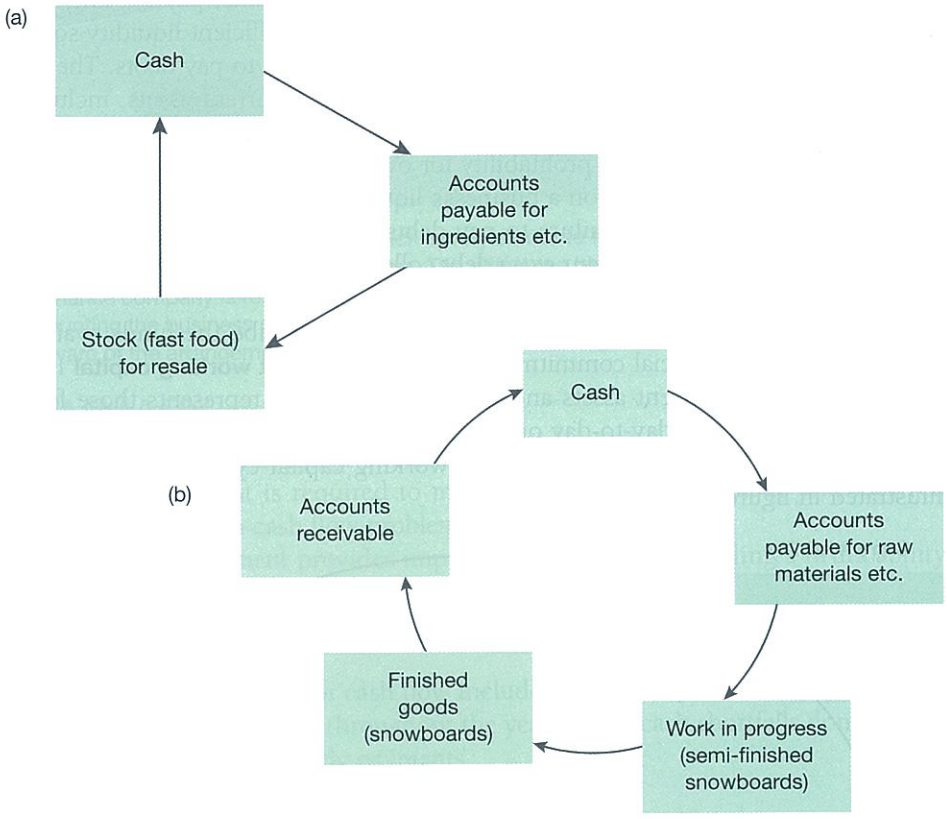


FIGURE 12.4 The requirements for working capital vary for each business. (a) A food outlet requires a relatively low level of working capital as its cash flow cycle is short. (b) A snowboard manufacturer requires a higher level of working capital as the cash flow cycle — between paying for raw materials and receiving payment for finished goods sold — is longer.

BizFACT

Many businesses are profitable and yet they have a cash flow problem. Profit does not equal cash and cash does not equal profit. Many profitable businesses get into difficulty because they have a working capital problem.

12.3.1 The current (working capital) ratio

As outlined in chapter 11, the current (working capital) ratio shows if current assets can cover current liabilities. That is, it helps to determine whether a business is managing cash flows so that it can pay its immediate debts. The ratio indicates the amount of risk taken by a business in relation to profitability and liquidity, and can help determine whether the business's financial structure is acceptable. For example:

$$\text{Current (working capital) ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

$$= \frac{500\,000}{250\,000}$$

$$= 2{:}1 \text{ or } 200\%$$

In this example, the ratio indicates that, within the next 12 months, twice the amount of assets need to be sold to generate cash to meet the short-term debts of the business for the same period.

A high current ratio may indicate the business has invested too much in current assets that bring in a small return. Profitability may be reduced as the business has chosen to reduce its risk of not being able to pay its debts by having a higher current ratio. A low current ratio may mean that the business is more profitable if it is investing its resources in longer term assets and generating more profits. However, there is a risk that the business may not be able to pay its current liabilities.

A current ratio of 2:1, or 200 per cent, is generally acceptable, but ratios vary depending on the industry, the type of business, the efficiency of the business in being able to convert current assets into cash, and the relations with creditors and banks that are sources of cash. Each business determines an appropriate current ratio, but the careful monitoring of working capital is important for the survival of a business. Figure 12.5 shows the importance of working capital management.

	2016	2017
Current Assets	$m	$m
Bank	3.4	0
Accounts receivable	30.6	34.8
Short-term investments	6.7	4.2
Inventory	21.6	25.1
	62.3	64.1
Current Liabilities		
Overdraft	0	4.6
Accounts payable	22.3	20.4
Short-term loans	17.8	19.2
	40.1	44.2
Working capital	22.2	19.9

Working capital = Current assets – Current liabilities

2016 = 62.3 – 40.1

= $22.2m

2017 = 64.1 – 44.2

= $19.9m

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

$$2016 = \frac{62.3}{40.1}$$

= 1.55:1 (155%)

$$2017 = \frac{64.1}{44.2}$$

= 1.45:1 (145%)

- Current assets have increased in total over the two periods but at a slower rate than current liabilities. Working capital has fallen by $2.3m ($22.2m – $19.9m).
- There has been an increase in current liabilities ($17.8m to $19.2m).
- Current ratio has changed from 1.55:1 (155 per cent) to 1.45:1 (145 per cent). Management must decide whether this ratio and trend is acceptable.
- Bank has moved from a surplus to an overdraft ($0 to $4.6m). This would need to be evaluated in terms of the costs.
- Accounts receivable has increased ($34.8m – $30.6m = $4.2m) by over 10 per cent ($4.2m/30.6m = 13.7 per cent).
- Accounts payable has fallen ($22.3m to $20.4m).

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- Short-term investments have fallen ($2.5m from $6.7m to $4.2m).
- Short-term loans have increased ($1.4m from $17.8m to $19.2m).

It would appear that short-term loans are balanced by accounts payable and short-term investments with accounts receivable. Management must examine this in the light of past experience and business policy.

Inventories have increased significantly ($3.5m from $21.6m to $25.1m). The reasons for this change should be investigated.

Although the current ratio has declined a little, there is sufficient liquidity (current assets) to fund current liabilities.

FIGURE 12.5 An example of current (working capital) ratio

12.3.2 Control of current assets

Management of current assets is important for monitoring working capital. Excess inventories and lack of control over accounts receivable lead to an increased level of unused assets, leading in turn to increased costs and liquidity problems. Excess cash is a cost if left idle and unused. On the other hand, insufficient inventories and tight credit control policies may also lead to problems.

Control of current assets requires management to select the optimal amount of each current asset held, as well as raising the finance required to fund those assets. The costs and benefits of holding too much or too little of each asset must be assessed. Working capital must be sufficient to maintain liquidity and access to credit (overdraft) to meet unexpected and unforeseen circumstances.

Cash

Cash is critical for business success, and careful consideration must be given to the levels of cash that are held by a business. Cash ensures that the business can pay its debts, repay loans and pay accounts in the short term, and that the business survives in the long term. Supplies of cash also enable management to take advantage of investment opportunities, such as the short-term money market.

Planning for the timing of cash receipts, cash payments and asset purchases avoids the situation of cash shortages or excess cash. Cash shortages can, however, occur due to unforeseen expenses and they are a cost to the business. Money may need to be borrowed, incurring interest and perhaps set-up costs.

Businesses try to keep their cash balances at a minimum and hold marketable securities as reserves of liquidity. Reserves of cash and marketable securities guard against sudden shortages or disruptions to cash flow. An overdraft might also be arranged to allow a business to overdraw its account to an agreed overdraft amount.

Receivables (accounts receivable)

The collection of **receivables** is important in the management of working capital. Consequently, a business must monitor its accounts receivable and ensure that their timing allows the business to maintain adequate cash resources. The quicker the debtors pay, the better the firm's cash position. Procedures for managing accounts receivable include:

- checking the credit rating of prospective customers
- sending customers' statements monthly and at the same time each month so that debtors know when to expect accounts
- following up on accounts that are not paid by the due date
- stipulating a reasonable period, usually 30 days, for the payment of accounts
- putting policies in place for collecting bad debts, such as using a debt collection agency.

The disadvantage of operating a tight credit control policy is the possibility that customers might choose to buy from other firms. The costs and benefits must be weighed up carefully by management.

BizWORD

Receivables *are sums of money due to a business from customers to whom it has supplied goods or services. Receivables are recorded as accounts receivable.*

BizFACT

Poor credit collection policies can increase delays in the receipt of money from accounts receivable and more working capital is needed to cover the shortfall. Non-current liabilities or owners' equity may be needed. The use of long-term liabilities to finance short-term liquidity problems may cause problems for the business in the longer term, as reduced finances mean less profit.

Aged debtors report

Name	Reference no.	Total	30 days	60 days	90 days	> 90 days
Isabella Faro	4671	150.00	150.00	0.00	0.00	0.00
Michael Gray	4784	405.00	405.00	0.00	0.00	0.00
John Flemming	4379	225.00	1650.00	0.00	0.00	1875.00
Anthony Tran	4469	280.00	280.00	0.00	0.00	0.00
Cathy Otter	4832	49.00	49.00	0.00	0.00	0.00
Totals		**1109.00**	**2534.00**	**0.00**	**0.00**	**1875.00**

FIGURE 12.6 One way some businesses manage their receivables is to prepare an aged debtors report. This lists any customers (debtors) that owe the business money, how much they owe the business and how long the payment is overdue. This makes it easy for a business to identify slow payers so that they do not issue them with additional credit until they've paid their outstanding debts.

Inventories

Inventories make up a significant amount of current assets, and their levels must be carefully monitored so that excess or insufficient levels of stock do not occur. Too much inventory or slow-moving inventory will lead to cash shortages. Insufficient inventory of quick-selling items may also lead to loss of customers, and hence lost sales.

Inventory is a cost to the business if it remains unsold: the holding of too much stock means unnecessary expenses (for example, storage and insurance costs). The rate of inventory or stock turnover differs depending on the type of business. For example, a fruit and vegetable merchant has a high turnover and pays for inventory close to the time of sale, whereas a motor vehicle dealer has a much slower stock turnover and usually pays for inventory well before a sale is made.

Businesses must ensure that inventory turnover is sufficient to generate cash to pay for purchases and pay suppliers on time so that they will be willing to give credit in the future.

12.3.3 Control of current liabilities

As previously explained, current liabilities are financial commitments that must be paid by a business in the short term. Minimising the costs related to a firm's current liabilities is an important part of the management of working capital. This involves being able to convert current assets into cash to ensure that the business's creditors (accounts payable, bank loans or overdrafts) are paid.

Payables (accounts payable)

A business must monitor its **payables** and ensure that their timing allows the business to maintain adequate cash resources. The holding back of accounts payable until their final due date can be a cheap means to improve a firm's liquidity position, as some suppliers allow a period of interest-free trade credit before requiring payment for goods purchased. It may also be possible to take advantage of discounts offered by some creditors. This reduces costs and assists with cash flow. Accounts must, however, be paid by their due dates to avoid any extra charges imposed for late payment and to ensure that trade credit will be extended to the business in the future.

Control of accounts payable involves periodic reviews of suppliers and the credit facilities they provide, for example:

- discounts
- interest-free credit periods
- extended terms for payments, sometimes offered by established suppliers without interest or other penalty.

BizFACT

Afterpay is a fairly recent digital service that makes it possible for customers to buy something now and pay it off in fortnightly instalments. The money owed by customers will form part of a business's receivables. Unlike lay-by, customers will get the product straight away and, if they meet the regular repayments, they won't be charged interest. Missing an instalment, however, will result in a $10 fee. This checkout method is quickly gaining popularity in Australia.

BizFACT

The inability to properly manage working capital led to the demise of Dick Smith. An investigation into the collapse found that the company had been purchasing excessive amounts of inventory that was worth less than what they could sell it for. Dick Smith had paid too much for stock that they couldn't sell profitably and their subsequent cash flow shortage made them insolvent.

BizWORD

Payables *are sums of money owed by the business to other businesses from whom it has purchased goods and services. Payables are recorded as accounts payable.*



FIGURE 12.7 According to ASIC poor financial control, including poor bookkeeping, was cited by 33 per cent of owners as the cause of business failure. Business owners need to set up an effective record system so they can accurately trace their accounts payable to ensure they know how much they owe each supplier and they make their payments on time. Failure to properly manage and track payables can lead to late payment penalties, damaged supplier relationships and even business failure.

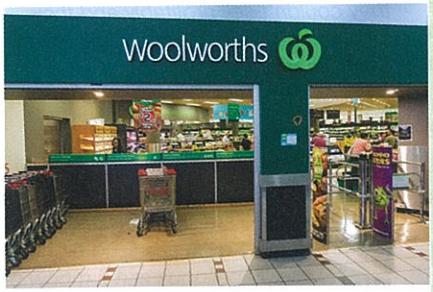
BizFACT

Businesses view trade credit as cost-free finance. For example, if a business buys goods from a supplier and the account is due for payment in 30 days, the business has 30 days of cost-free finance.

Alternative financing plans should be investigated with suppliers, such as floor plan and consignment finance. Motor vehicle dealers have slow stock turnover and often use floor plan or floor stock finance. This means that suppliers agree to provide the motor vehicles for a period of time before payment is due. Consignment financing is a similar arrangement — goods are supplied for a particular period of time and payment is generally not required until goods are sold. Goods supplied may also be returned if they are not sold within the designated period.

As there are costs involved in providing and receiving credit, businesses may negotiate reduced prices if credit card facilities are used. Costs and benefits in using credit must be determined in the control of accounts payable.

SNAPSHOT



'. . . nearly three-quarters of all business invoices are paid late.'

Delaying payment to suppliers to improve working capital

The holding back of accounts payable until their due date is one working capital management strategy that firms can use to improve their liquidity. However, many organisations are taking this one step further by paying their invoices late and delaying the payment of suppliers as long as possible. According to the ACCC, many large businesses have adopted this policy in an effort to manage their working capital. In fact, their research revealed that nearly three-quarters of all business invoices are paid late.

A report on trade credit and late payments in Australia was conducted by Dun & Bradstreet in 2017. Their analysis revealed that late payments have increased to their highest level, with businesses waiting an average of 44.9 days for payment. They also found that larger businesses were the slowest to pay invoices. The average late payment time for businesses in 2017 was 15.3 days late but for large businesses, this figure rose to 18.3 days late.

Many large companies have begun to tell their suppliers that their payment schedules will be extended from 30 days to sometimes up to 90 days or beyond. Some examples of high profile businesses delaying payments include Unilever and Nestlé, who average 90 days for repayment, and Kellogg's who have stretched their payment terms out to a staggering 120 days.

Woolworths has also faced some criticism recently due to their policy of delaying payments to most of their food and grocery suppliers. It currently takes them on average 51 days to settle debts with their suppliers and they are planning to extend this to 60 days in an attempt to improve their own working capital.

While this strategy will help Woolworths improve their liquidity, it has angered many of their suppliers who have admitted that they continuously have to chase invoices to secure payment. It takes Woolworths on average 22 days to sell their products,

so many suppliers feel this practice is unnecessary and that they are effectively being used as a cheap source of finance.

This policy by large corporations has become increasingly common but many small businesses have been too afraid to challenge their big customers and so have accepted whatever payment terms are offered. Kate Carnell, the Australian Small Business and Family Enterprise Ombudsman has recently called for the federal government to lead a campaign to ensure small businesses are paid on time and to introduce laws compelling large businesses to pay suppliers within 30 days. She has also urged the government to introduce additional recommendations requiring large businesses to publicly disclose their payment terms and their performance in relation to those terms.

SNAPSHOT QUESTIONS

1. **Identify** the average time it takes businesses to collect invoice repayments.
2. **Explain** the strategy many large businesses have adopted to improve their working capital.
3. **Assess** the impact of late payments.

Loans

Businesses may need to borrow funds in the short term for a number of purposes. Funds may be required to cover the sale and purchase of property, unforeseen circumstances, and import and export commitments. Short-term loans and bridging finance are important sources of short-term funding for businesses.

Management of loans is important, as costs for establishment, interest rates and ongoing charges must be investigated and monitored to minimise costs. Short-term loans are generally an expensive form of borrowing for a business and their use should be minimised. Control of loans involves investigating alternative sources of funds from different banks and financial institutions. Positive, ongoing relationships with financial institutions ensure that the most appropriate short-term loan is used to meet the short-term financial commitments of the business.

BizFACT

Approximately 23 per cent of SMEs have used a business loan. However, access to loans is a significant barrier for many Australian small businesses. Studies have shown that new businesses rely more heavily on credit cards, family and personal secured bank loans to fund their venture. Interest rates on SME loans are generally higher than those for large businesses and mortgages, which reflect the higher costs and risks associated with bank lending.

Overdrafts

As previously explained, overdrafts are a convenient and relatively cheap form of short-term borrowing for a business. They enable a business to overcome temporary cash shortages. Features of overdrafts differ between banks, but generally involve an arrangement with the bank that the business's account can be overdrawn to a certain amount. Banks may demand the immediate repayment of the overdraft, although this is rare, especially if the business has a good record and a positive relationship with the bank.



FIGURE 12.8 Approximately 19.6 per cent of SMEs use an overdraft, making it still a significant method of financing short-term cash flow. While many owners are tempted to use an overdraft to cover a temporary cash shortfall, they need to be careful of the high interest, charges and variety of fees associated with this form of credit.

studyon

Syllabus area 3
Topic 4
Concept 2

Working capital management: control of assets and liabilities
Summary screen and practice questions

Banks require that regular payments be made on overdrafts and may charge account-keeping fees, establishment fees and interest. Interest payable for an overdraft is usually less than that for a loan. Bank charges do, however, need to be carefully monitored, as charges vary depending on the type of overdraft established. Businesses should have a policy for using and managing overdrafts and monitor budgets on a daily or weekly basis so that cash supplies can be controlled.

12.3.4 Strategies for managing working capital

Businesses use a number of strategies to manage working capital, which is required to fund the day-to-day operations of a business. Strategies for working capital management include:

- leasing
- sale and lease-back.

BizWORD

Leasing *involves the payment of money for the use of equipment that is owned by another party.*

BizFACT

In 2015, Woolworths raised $15.3 million through the sale and lease-back of 10 Woolworths Petrol stations. The rationale was to use the cash that was tied up in owning the assets and the funds raised for other developments across the business. The petrol stations were sold with long-term leases to Woolworths. 7-Eleven also raised more than $200 million in sale and lease-back deals.

BizFACT

Village Roadshow, Gold Coast theme park owner, made a decision in 2017 to sell the land that is home to Warner Bros. Movie World and Wet'n'Wild theme parks. They were hoping to make $100 million on the sale. As part of the deal, Village Roadshow will lease back the land so they can continue operating the parks for at least the next 30 years.

BizWORD

Sale and lease-back *refers to the process of selling an owned asset to a lessor and then leasing the asset back through fixed payments for a specified period of time.*

Leasing

Leasing involves the payment of money for the use of equipment that is owned by another party. A lease is a contract between the lessor (owner of the asset) and the lessee (user of the asset) that lets the lessee rent an asset for a period of time in exchange for periodical payments.

Some advantages of leasing include:

- The cash outflows (payments) related to leasing are spread over several years as opposed to the one-off large initial cash outflow that would occur if the business had to purchase the asset outright. This helps improve working capital.
- It allows the business to make use of good quality assets, which might have been unaffordable or expensive if they had to purchase them outright.
- Lease payments are considered operating expenses and are therefore tax deductible.
- It allows businesses the flexibility to upgrade to new and better assets as and when it is necessary without having to make a large cash outlay purchasing new equipment once an asset becomes outdated.
- It reduces the risk of technological obsolescence since the leased asset can be upgraded.
- Depending on the terms of the agreement, it reduces the risk of unpredictable costs associated with the repairs and maintenance of equipment.
- The lease payments help with cash flow forecasting and budgeting as the payments are fixed for a specified time. Businesses will know at the outset what the payments will be for the duration of the lease and the repayments won't fluctuate over time like other forms of borrowing.

Sale and lease-back

Sale and lease-back refers to the process of selling an owned asset to a lessor and then leasing the asset back through fixed payments for a specified period of time. The lessor retains ownership of the asset as part of the agreement. The biggest advantage of sale and lease-back is that it helps improve a business's liquidity since it enables the business to receive a large cash injection from the sale of the asset, which can then be used as working capital if the business is experiencing a cash shortfall. The business still continues to benefit from the use of the asset. This strategy shares many of the same advantages as leasing.

Cash cows fund China dairy firm that defied stock market slump

By Lisa Pham (Bloomberg) — 25 May 2016 — with assistance from Moxy Ying

In the creative world of Chinese lending, there's a new trade in town: the cow leaseback.

China Huishan Dairy Holdings Co., which operates the largest number of dairy farms in the country, is selling about a quarter of its herd — some 50,000 animals — to Guangdong Yuexin Finance Lease Co. for 1 billion yuan (US$152 million) and then renting them back.

With an estimated US$1.3 trillion of risky loans in the country, Chinese banks are becoming more cautious about lending, forcing some companies to look for new ways to borrow. Finance leasing has been growing in popularity, especially for purchases of equipment.

But cows?

'It's not very common to use cows as collateral', said Robin Yuen, an analyst at RHB OSK Securities Hong Kong Ltd. 'The value of a cow would fluctuate depending on milk prices and other factors, so it's a risky asset for lenders. It would be hard to do forced selling — there's no liquid market for a large number of cows.'

In Huishan Dairy's case, an increasingly common one in a China of rising debts, slumping commodity prices and the propensity of Chinese executives to use their shares as collateral for private loans.

...

That's fine if the shares are rising, but in the volatility of the past year, many stocks slumped, prompting lenders who held them as guarantees for loans to demand the borrower supply more collateral.

'Huishan Dairy seems to be selling cows and leasing them back in order to raise money now, because they've been using cash to buy back shares', said RHB's Yuen, who has a 'sell' rating on the stock. 'The chairman wants to prop up the share price for reasons that are unclear. It could be a way to get better terms for share pledged-based loans, which he's done before.'

Company Chairman Yang Kai has been building up his stake in the company to almost 74 per cent, according to the latest disclosure of interests to the stock exchange. 'Yang pledged shares he owned to Ping An Bank Co. to finance the buybacks', RHB said in a research note on 28 January 2016.

Meanwhile, the company itself spent HK$1.93 billion (US$249 million) buying back 820.2 million shares in the six months ended September, equivalent to almost twice its cash from operations for the same period.

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The share buybacks helped Huishan Dairy's share price jump 72 per cent since the beginning of July, even as Hong Kong's benchmark Hang Seng Index fell 22 per cent.

Still, keeping the stock price buoyant drained cash as milk prices were slumping and the company's debts were rising. Huishan had 10.4 billion yuan of bank loans at the end of September, with more than half needing to be repaid within a year. The value of short-term bank loans had more than doubled compared to six months earlier.

Whole milk powder prices, meanwhile, have plunged, with the latest GlobalDairyTrade auction price of US$2252 a metric ton on 17 May 2016 down 57 per cent from a peak in April 2013.

So the company turned some of its cows into cash, leasing them back through a unit at an annualised interest rate of as much as 6.2 per cent, with an option to repurchase the cattle at the end of the five years.

...

As dairy cows are typically slaughtered after about five years, when their production declines, the agreement included provisions to cull and replace animals regularly.

'Huishan Dairy's gearing was more than 60 per cent last year, so it's not a bad idea for the company to get a loan for working capital', said Anson Chan, an analyst

SNAPSHOT



'. . . there's a new trade in town: the cow leaseback.'

at Daiwa Capital Markets, who also recommends investors 'sell' the shares. 'The interest rate for the finance lease is lower than the company's current bank loans.'

The growth of finance leasing in China is partly a reflection of the broadening of the nation's banking system. 'Most contracts involve the leaseback of equipment', said Shujin Chen, a banking analyst at DBS Vickers Hong Kong Ltd. They totalled about 4 trillion yuan at the end of 2015, with the percentage of equipment purchased by finance leasing at about 7 per cent to 8 per cent, compared to only 1 percent in 2008, she said.

'Finance leases offer tax advantages, asset flexibility and cash flow certainty', Chen said in an e-mail. In China they account for around 4 per cent to 5 per cent of bank loans, compared with about 22 per cent in 2013 in the United States, where cow leasing has fallen out of favour.

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SNAPSHOT QUESTIONS

1. **Outline** how Huishan Dairy Holdings Co. manages their working capital.
2. **Assess** the impact of the strategy outlined in question 1.

studyon

Syllabus area 3
Topic 4
Concept 3

Working capital management strategies
Summary screen and practice questions

SUMMARY

- Working capital refers to the funds available for the short-term financial commitments of a business.
- Net working capital is the difference between current assets and current liabilities. It represents those funds that are needed for the day-to-day operations of a business to produce profits and provide cash for short-term liquidity.
- Control of current assets refers to the management process that determines the optimal amount of each current asset held. This includes:
  - *cash*. Careful consideration must be given to the levels of cash that are held by a business.
  - *receivables*. A business must monitor its accounts receivable and ensure their timing allows the business to maintain adequate cash resources.
  - *inventories*. The level of inventory must be carefully monitored so that excess or insufficient levels of stock do not occur.
- Control of current liabilities refers to the management process that determines the optimal amount of each current liability held. This includes:
  - *payables*. A business must monitor their accounts payable and ensure their timing allows the business to maintain adequate cash resources.
  - *loans*. Businesses may need to borrow funds in the short-term for a number of purposes. The management of these loans is important.
  - *overdrafts*. This is a relatively cheap and convenient form of short-term borrowing that can be used to cover a temporary cash shortage.
- Other strategies for managing working capital include:
  - leasing — a contract between the lessor (owner of the asset) and the lessee (user of the asset) that lets the lessee rent an asset for a period of time in exchange for periodical payments
  - sale and lease-back — the process of selling an owned asset to a lessor and then leasing the asset back through fixed payments for a specified period of time.

EXERCISE 12.2 REVISION

1 **Distinguish** between working capital and net working capital.
2 **Why** is working capital important to a business?
3 'Too much working capital is as bad as not enough working capital.' **Interpret** this statement.
4 **Construct** a diagram to **demonstrate** the working capital cycle of a business that sells computers and computer software, and provides repair services for

computer hardware. The business generates $3 million in sales, $1 million in repairs; it has inventory valued at $500 000, accounts receivable to the value of $230 000, accounts payable to the value of $44 000 and $58 000 in cash.

5 **Why** is the current (working capital) ratio important?

6 **Outline** working capital management strategies businesses can implement to control their current assets.

7 **Outline** working capital management strategies businesses can implement to control their current liabilities.

8 **Discuss** the working capital management strategy of leasing.

9 **Explain** how sale and lease-back can improve a business's working capital.

10 (a) **Clarify** what a current ratio of 3.5:1 (350 per cent) represents.
(b) **Explain** whether this is a satisfactory or unsatisfactory ratio. (N.B. Take care with this question.)

11 **Why** is the management of cash so important to a business?

12 KJ Carpet Cleaning operates on a cash-only basis.
(a) **Describe** the working capital cycle for KJ Carpet Cleaning.
(b) **Determine** what the advantages and disadvantages are of cash only for KJ.

13 Simon and Kim's Drafting Services has a wide client base and 90 per cent of their fees are on credit. Simon and Kim allow 90 days payment of their drafting services.
(a) **Identify** what potential problems in relation to their credit policy that Simon and Kim's Drafting Services might experience.
(b) **Propose** the recommendations you would make to the business.

14 Using the information for a soft toys manufacturer below, answer the following questions.
(a) **Calculate** the amount of working capital for the business.
(b) **Outline** the apparent success of managing accounts receivable (all sales are on credit).
(c) **Identify** the amount of inventory in relation to working capital.
(d) **Identify** the amount of cash retained in the business.
(e) **Propose** the recommendations you would make to management in relation to the management of current assets.
(f) **Calculate** the current ratio and comment on the level of the ratio.
(g) If the ratio for the previous two periods was, respectively, 220 per cent and 240 per cent, **deduce** the trend.
(h) **Calculate** the current liabilities of the business and **recommend** how to manage its liabilities in the future. (Hint: consider that the business may choose to expand in size.)

Financial status of soft toy manufacturer	
Cash	5 900
Inventory	2 800
Accounts receivable	2 500
Plant and equipment	45 000
Accounts payable	4 200
Long-term loans	20 000

15 Answer the following questions by referring to the aged debtors report in figure 12.6.
(a) **Identify** which debtor owes $49.
(b) **Identify** which debtor is taking the longest to repay their debt. How many days is their repayment overdue?
(c) **How** much money is 30 days overdue?

EXERCISE 12.2 EXTENSION

1 'Over-investment in working capital ties up cash flow.' 'Under-investment in working capital reduces profits.' **Analyse** these statements.

2 **How** do inflation and fluctuating business cycles affect working capital?

3 **Explain**, with examples, how cash flow relates to working capital management.

4 **How** might a business have a high current ratio but experience difficulties in finding cash to pay its suppliers?

5 **Create** a report to management with recommendations on controlling assets to manage working capital.

6 Find information online about the services of the Commonwealth Bank.
   (a) **Create** a concept map that includes the main services provided by this institution to financially assist businesses. (Hint: this includes a lot more than just loans.)
   (b) Use the calculator provided on the Commonwealth Bank website to compare the business credit card options. **Recommend** and **justify** one credit card option for a small business of 20 employees.

on Resources

Weblink: Commonwealth Bank

12.4 Profitability management

BizWORD

Profitability management *involves the control of both the business's costs and its revenue.*

Profitability management involves the control of both the business's costs and its revenue. Accurate and up-to-date financial data and reports are essential tools for effective profitability management.

12.4.1 Cost controls

Most business decisions — for example, to open a new store or buy a new piece of machinery — are influenced by costs. The costs associated with a decision need to be carefully examined before it is implemented.

Fixed and variable costs

Before a business can control its costs, management must have a clear understanding of what those costs are. As outlined in chapter 2, businesses generally have fixed costs and variable costs.

BizWORD

Fixed costs *are those that are not dependent on the level of operating activity in a business. Fixed costs do not change when the level of activity changes — they must be paid regardless of what happens in the business.*

Variable costs *are those that vary in direct relationship to the levels of operating activity or production in a business. Such costs include labour costs and costs of energy.*

Fixed costs are not dependent on the level of operating activity in a business. Fixed costs do not change when the level of activity changes — they must be paid regardless of what happens in the business (see figure 12.9). Examples of fixed costs are salaries, depreciation, insurance and lease. (In reality, fixed costs can change — for example, if new premises are needed then leasing costs will increase — but, once the changes are made, the costs again become fixed.)

Variable costs are those that vary in direct relationship to the levels of operating activity or production in a business. Such costs include labour costs and costs of energy (see figure 12.9). For example, materials and labour used in the production of a particular item are variable costs, because they are often readily identifiable in a business and can be directly attributable to a particular product.

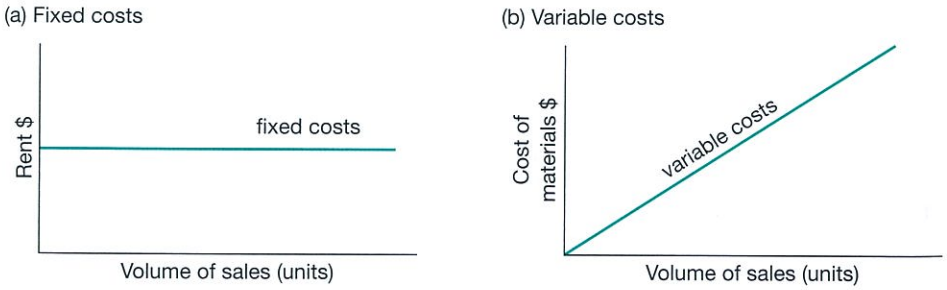


FIGURE 12.9 A simplified illustration of (a) fixed costs and (b) variable costs

Monitoring the levels of both fixed and variable costs is important in a business. Changes in the volume of activity need to be managed in terms of the associated changes in costs. Comparisons of costs with budgets, standards and previous periods ensure that costs are minimised and profits maximised.

Cost centres

A business's costs must be accounted for and management needs to be able to identify their source and amounts. A number of costs can be directly attributable to a particular department or section of a business, and these are termed **cost centres**. A cost centre is a department within a business that is responsible for a particular set of activities that benefits the organisation. By treating the cost centre as a separate unit, the business can measure how much they are spending on that function each year. It allows management to measure, budget and control costs for each specific function.

The use of cost centres helps management utilise resources more efficiently as it gives them a better understanding of how those resources are being used. The main function of a cost centre is to track expenses. Monitoring expenses through the use of cost centres allows for greater control of total costs. Examples of cost centres include the IT department, human resources department, accounting department and maintenance staff. Cost centres are not limited to departments, however, in some instances there may be several cost centres within one department. For instance, within the manufacturing department, each assembly line could be a cost centre.

BizWORD

Cost centres *are particular areas, departments or sections of a business to which costs can be directly attributed.*

studyon

Syllabus area 3
Topic 4
Concept 4

Profitability management: cost controls
Summary screen and practice questions

Expense minimisation

Profits can be weakened if the expenses of a business are high, as they consume valuable resources within a business. Guidelines and policies should be established to encourage staff to minimise expenses where possible. Savings can be substantial if people take a critical look at costs and eliminate waste and unnecessary spending.

Case study: IKEA cutting costs

While many retailers devote a lot of time trying to figure out how to charge more for their goods, IKEA's success has been based on the relatively simple idea of minimising costs. They pursue a cost leadership strategy and are constantly trying to do everything a little simpler, more efficiently and cost effectively.

Five ways IKEA minimises costs include:

- *design.* IKEA's designs are simple, functional and efficient to manufacture in large mass-produced batches. IKEA uses fewer low-cost materials and their pieces are designed to include minimal parts in order to cut down on supplier and manufacturing costs.
- *supplier partnerships.* IKEA established long-term partnerships with their suppliers and order supplies in high volumes to take advantage of economies of scale and keep costs down.
- *packaging.* All their pieces are designed so that they can be packaged efficiently. IKEA pioneered the flat-pack model for their furniture. Their furniture is sold in pieces that are placed into convenient and efficient flat packages, which take up less room in trucks and maximise the number of products that can be shipped. Since their packages are flat, trucks are filled to maximum capacity, which saves on fuel and transportation costs. They also save on storage costs since each piece of furniture takes up less space in their warehouse.
- *location.* IKEA stores are generally located outside major city centres (although within driving distance) where huge spaces of land can be acquired cheaper.
- *production.* IKEA mass produces a limited number of products in order to achieve economies of scale.

SNAPSHOT QUESTIONS

1. **Summarise** IKEA's expense minimisation strategies.
2. **Explain** the effect of these strategies on IKEA's profitability.

SNAPSHOT



'. . . IKEA's success has been based on . . . minimising costs.'

12.4.2 Revenue controls

BizFACT

Budgets and cost-volume-profit analysis are the tools used in the control of revenue.

Revenue is the income earned from the main activity of a business. For most businesses, revenue comes from sales or, in the case of a service business, from fees for professional services or commission. In determining an acceptable level of revenue with a view to maximising profits, a business must have clear ideas and policies, particularly about its marketing objectives including the sales objectives, sales mix or pricing policy.

Marketing objectives

Marketing strategies and objectives should lead to an increase in sales and hence an increase in revenue. Sales objectives must be pitched at a level of sales that will cover costs, both fixed and variable, and result in a profit. A cost-volume-profit analysis can determine the level of revenue sufficient for a business to cover its fixed and variable costs to break even, and predict the effect on profit of changes in the level of activity, prices or costs.

Changes to the sales mix can affect revenue (see figure 12.10). Businesses should control this by maintaining a clear focus on the important customer base on which most of the revenue depends before diversifying or extending product ranges or ceasing production on particular lines. Research should be carried out to identify the potential effects of sales-mix changes before decisions are made.



FIGURE 12.10 Changes to the sales mix can affect revenue. In 2016, McDonald's introduced its all-day breakfast menu. Same-store sales increased over 5 per cent after this alteration to the sales mix was introduced. The menu change clearly paid off.

BizFACT

Profit is what remains after all business costs have been deducted from sales revenue.

Pricing policy affects revenue and, therefore, affects working capital. Pricing decisions should be closely monitored and controlled. Overpricing could fail to attract buyers, while underpricing may bring higher sales but may still result in cash shortfalls and low profits. Factors that influence pricing include:

- the costs associated with producing the goods or services (materials, labour, overheads)
- prices charged by the competition
- short- and long-term goals — for example, if the business aims to improve market share over a five-year period, prices may be reduced
- the image or level of quality that people associate with the goods or services
- government policies.

Profitability — pricing

Working out the best price to charge for your products or services can be one of the biggest challenges you face, particularly when starting out. Price too low, and you'll be out of business before you know it; price too high, and you're out of the market. Get your pricing just right, however, and you'll maximise your profits.

There's no magic formula that can help you to price perfectly, but there are several basic principles, and if you take the time to apply them, you can hit the sweet spot.

Selling yourself short

Underpricing is rife in small businesses, particularly service businesses with low overheads. The logic goes that if you can afford to charge less, you should.

Stephen Craft, who runs a specialist financial copywriting business, learnt this the hard way. Despite writing about finance for a living, he made the same pricing mistake as many other small businesses:

'When I first ran my own business, I set my rates by looking at similar small businesses,' he says. 'I had lower overheads, so I figured that I could undercut them and still come out ahead. Later, I went to work in-house for one of my largest clients. Then I discovered what they were really willing to pay for what I did — and it was a lot more than I'd been charging.

'It turned out that my competitors were not who I thought they were [other small businesses]. My client had been comparing me to big companies with high overheads and heavy workloads. For my client, the big attraction of my business was speed and responsiveness. Not price.'

Apples vs oranges

The key point here is to know what you're really selling. Is it your product or service? Or is it something else, like convenience, speed or reliability? In other words, what is your unique selling proposition (USP)?

Quite simply, price is not always the most important factor for a customer. Once you understand your USP and your customer, you can charge accordingly. Value might mean improving your service, rather than charging lower prices.

You need to know how sensitive your market is generally to changes in price. Can you increase prices without losing business? Or can you drive extra sales with a small reduction in prices? Are you in a niche market where your customers are not particularly price-sensitive?

You also need to determine whether you're running a low-margin, high-turnover business or a high-margin, lower-turnover business. The former will be priced for sales, the latter for profit.

The numbers game

Once you've got a handle on your USP, and your market, it's time to look at the numbers.

First you need to know your costs. Your pricing may ultimately be determined by other factors discussed already in section 12.4.2, but your costs are a crucial benchmark. Your variable costs are the cost price of a product (or an hour's wages, for a service business). Your fixed costs include things like rent, wages, interest payments and all the other bills you have to pay. Don't forget to include the real costs of labour, such as leave, Super, and so on. And don't discount your own time.

Your break-even point is when revenues (the income from your sales) exactly cover your expenses. Everything over that is profit.

Profit margins

In the end, what you're after is profit. Depending on the type of business you're in, you should know what's a realistic profit margin. So when you price your products or services, you add mark-ups to their total cost (that's both fixed and variable costs) to give you the profit margin that you want. (*Note:* mark-up is what you add to the cost; margin is a percentage of the selling price.)

SNAPSHOT



'Quite simply, price is not always the most important factor for a customer.'

Table 1 shows the mark-up you need to apply (as a percentage of cost price) to achieve your desired margin.

Of course, you can't just decide that you want a 50 per cent profit margin. Whatever profit margin you're aiming for, you need to know that the market will take it.

TABLE 1 The mark-up you need to apply (as a percentage of cost price) to achieve your desired margin

Margin % of selling price	Mark-up % of cost price
5	5.3
10	11.1
15	17.1
20	25
25	33.3
30	42.9
35	53.9
40	66.7
45	81.82
50	100

'In most cases, you can't just increase your prices on a whim.'

Discounting: yay or nay?

In most cases, you can't just increase your prices on a whim. Likewise, you should think hard before discounting. There are going to be times for many businesses when discounting is appropriate — you may be happy to charge a lower hourly rate for a client who is going to pay a retainer or bring a lot of business, or you may discount to clear end-of-season stock. But be clear-headed — if you have to cut prices to win a customer, is this a customer you want?

If you're discounting to drive sales, you need to know how much your sales have to increase after a price cut for you to break even. Table 2 can help with this.

TABLE 2 Price discounts: percentage increase in sales to break even after a price cut

	Current gross profit margin							
Price cut (%)	10	20	30	40	50	60	70	80
5	100.0	33.3	20.0	14.3	11.1	9.1	7.7	6.7
10		100.0	100.0	33.3	25.0	20.0	16.7	14.3
15		300.0	100.0	60.0	42.9	33.3	27.3	23.1
20			200.0	100.0	66.7	50.0	40.0	33.3
25			500.0	166.7	100.0	71.4	55.6	45.5
30				300.0	150.0	100.0	75.0	60.0
35				700.0	233.3	140.0	100.0	77.8
40					400.0	200.0	133.3	100.0
45					900.0	300.0	180.0	128.6
50						500.0	250.0	166.7

Source: © 'The price is right or is it?', by Tiffany Hutton, *Dynamic Business Magazine*, March 2011, pp. 28

A final word

In the end, your pricing decisions have to be your own. Don't be tempted to follow the pricing strategy of a competitor — no matter how similar they may appear, your business is unique, with its own cost structures and customer base, so it deserves its own pricing strategy.

SNAPSHOT QUESTIONS

1. **Outline** what is meant by underpricing and **explain** why it is detrimental to long-term success for a business.
2. **Explain** the importance of a business understanding its unique selling position (USP) and how this relates to pricing and profit.
3. **Explain** how the pricing process is ultimately decided by a business.
4. **Outline** the meaning of profit margin and how this relates to the market in which the business operates.
5. **Explain** discounting and **identify** the factors that must be considered before a business undertakes this as a pricing option.

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Syllabus area 3
Topic 4
Concept 5

Profitability management: revenue controls
Summary screen and practice questions

12.5 Global financial management

12.5.1 Comparing the risks involved in domestic and global financial transactions

The growth of global business has resulted in economic expansion for many countries, as well as bringing extra concerns.

Financial risks were examined in section 11.2.4. Global businesses, however, bring extra concerns and risks for financial managers — in particular, currency fluctuations/exchange rates, interest rates, methods of international payment, hedging and derivatives.

Financial risks associated with global expansion are greater than those encountered domestically, but such risk taking is necessary for the business strategy to be implemented.

Largely 'uncontrollable' financial influences include currency fluctuations, interest rates and overseas borrowing. 'Uncontrollable' means that these influences are part of the external business environment and may not be significantly controlled by the business. However, a business can put in place appropriate financial management strategies to minimise their negative effects.

One of the most difficult financial influences to manage is currency (exchange rate) fluctuations.

BizFACT

A number of larger financial institutions offer a range of services to facilitate the financial management of global business.

12.5.2 Exchange rates

Countries have their own currency, which they use for domestic purposes. This means that when transactions are conducted on a global scale, one currency must be converted to another. For example, if an Australian business (importer) purchases machinery from Japan, the Japanese firm (exporter) will want to be paid in Japanese yen, not Australian dollars. Similarly, if a Japanese tourist visits Australia, he or she will pay for accommodation, restaurant meals and other products in Australian dollars, not yen. Therefore, in all global transactions it is necessary to convert one currency into another. This transaction is performed through the **foreign exchange market**, commonly abbreviated to **forex** or **fx**, which determines the price of one currency relative to another.

BizWORD

*The **foreign exchange** (**forex** or **fx**) **market** determines the price of one currency relative to another.*

Foreign exchange dealers around the world are constantly buying and selling each other's currency. In this way, the price or value of each country's currency is established. This value or price is called the exchange rate.

The **foreign exchange rate** is the ratio of one currency to another; it tells how much a unit of one currency is worth in terms of another. For example, if A$1 = US$0.70, that means one Australian dollar is worth 70 US cents. Conversely, one US dollar would be worth A$1.43.

BizWORD

*The **foreign exchange rate** is the ratio of one currency to another; it tells how much a unit of one currency is worth in terms of another.*



FIGURE 12.11 Foreign exchange trading involves the buying of one currency and the selling of another currency in an attempt to make a profit. This is done by speculating on the value of one currency in comparison to another. Foreign currencies can be traded because exchange rates fluctuate all the time. Foreign exchange trading is very complex and risky since it is extremely difficult to predict movements in currencies.

Effects of currency fluctuations

Exchange rates fluctuate over time due to variations in demand and supply.

Such fluctuations in the exchange rate create further risk for global business. For example, suppose that the value of the Australian dollar rises from US$0.70 to US$0.95. This upward movement of the Australian dollar (or another currency) against the US dollar is called an **appreciation**. (Of course, this means that the

BizWORD

An **appreciation** *is an upward movement of the Australian dollar (or any other currency) against another currency.*

value of the US dollar has decreased against the Australian dollar, with one US dollar being worth A$1.05.)

The impact of this currency fluctuation is twofold:

1. A currency appreciation raises the value of the Australian dollar in terms of foreign currencies. This means that each unit of foreign currency buys fewer Australian dollars. However, one Australian dollar buys more foreign currency. Therefore, an appreciation makes our exports more expensive on international markets but prices for imports will fall. The result of the appreciation, therefore, reduces the international competitiveness of Australian exporting businesses.
2. A currency depreciation has the opposite impact. A depreciation lowers the price of Australian dollars in terms of foreign currencies. Therefore, each unit of foreign currency buys more Australian dollars. The result is that our exports become cheaper and the price of imports will rise.

A depreciation, therefore, improves the international competitiveness of Australian exporting businesses.

Currency fluctuations, therefore, significantly impact on the profitability of global businesses. When revenues and expenses are transferred between nations, the exchange rate can either increase or decrease their value. Currency fluctuations will also affect the business's ability to meet their financial objectives.

BizFACT

In 2017, the Australian dollar increased above US$0.80, its highest level since 2015. This result was a combination of the US dollar getting weaker against most other major currencies, as well as a renewed demand for Australia's raw commodities, in particular iron ore. The Australian dollar was also stronger against the Japanese yen.

12.5.3 Interest rates

A business that plans to either relocate offshore or expand domestic production facilities to increase direct exporting will normally need to raise finance to undertake these activities. A global business has the option of borrowing money from financial institutions in Australia, or they can borrow money from financial markets overseas. Traditionally, Australian interest rates tend to be above those of other countries, especially the United States and Japan. Thus, Australian businesses could be tempted to borrow the necessary finance from an overseas source to gain the advantage of lower interest rates.

However, the real risk here is exchange rate movements. Any adverse currency fluctuation could see the advantage of cheaper overseas interest rates quickly eliminated. In the long term, the 'cheap' interest rates may end up costing more. Changes in interest rates will therefore have a major impact on a business's profitability if they have borrowed money from finance markets overseas.

studyon

Syllabus area 3
Topic 4
Concept 6

Global business management: issues
Summary screen and practice questions

12.5.4 Methods of international payment

One of the most crucial aspects of global financial management is to select an appropriate method of payment. Payment can be complicated by the fact that the business may be dealing with someone they have never seen, who speaks another language, uses a different monetary system, who abides by a different legal system and/or who may prove difficult to deal with if problems occur later on. One major worry for the exporter is that if the products are shipped before payment is received, there may be no guarantee that the importer will pay.

On the other hand, the buyer is faced with a similar situation. The importer may worry that if payment is sent before the products are received, there is similarly no guarantee that the exporter will send the products. This dilemma is as old as global business itself. Neither party completely trusts the other.

To solve this problem, a method of payment using a third party, who both parties trust, is required. This third party is normally a bank, which acts in an intermediary role. Figure 12.12 provides a simple explanation of the payment procedures when a product is exported from Australia to Japan. Note how both parties agree to the contract price being written in US dollars.

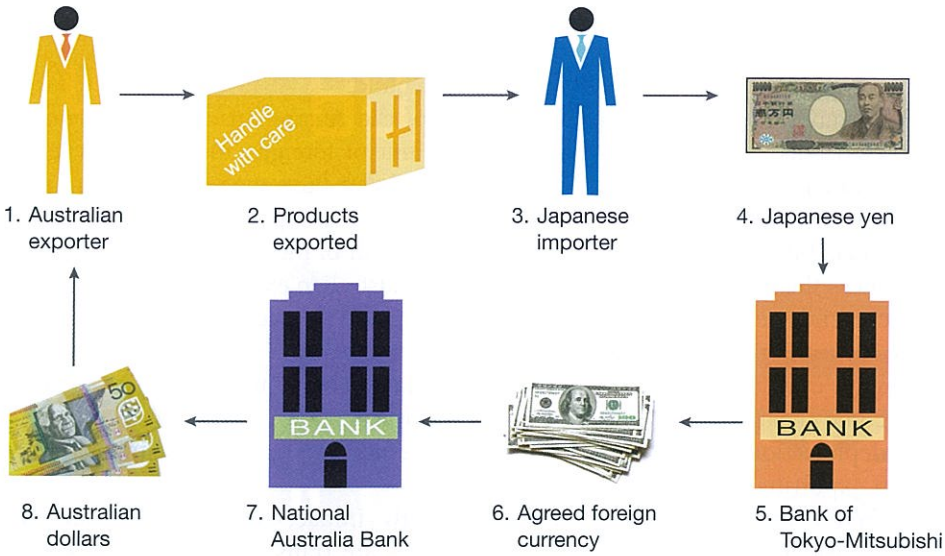


FIGURE 12.12 Simple international payment system showing the intermediary role of banks

There are four basic methods of payment from which a business can select:

- payment in advance
- letter of credit
- clean payment
- bill of exchange.

The option selected will largely depend on the business's assessment of the importer's ability to pay — that is, the importer's creditworthiness. Of course, as with all financial transactions, each method carries varying degrees of risk, especially when credit payments are involved (see figure 12.13).

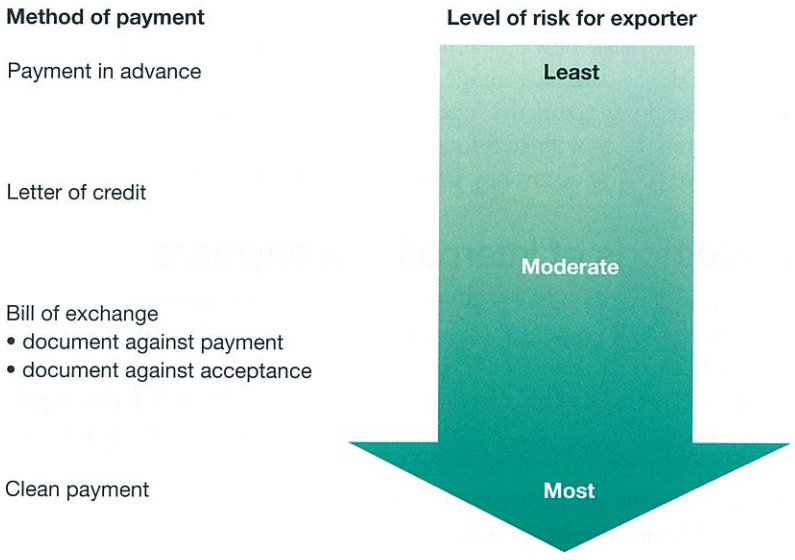


FIGURE 12.13 Degree of credit risk for different methods of international payment

The following section discusses the different methods of payment in order of increasing risk to the exporter.

BizWORD

The **payment in advance** *method allows the exporter to receive payment and then arrange for the goods to be sent.*

Payment in advance

The **payment in advance** method allows the exporter to receive payment and then arrange for the goods to be sent. This method exposes the exporter to virtually no risk and is often used if the other party is a subsidiary or when the credit worthiness

of the buyer is uncertain. However, very few importers will agree to these terms because it exposes them to the most risk. Furthermore, they have no guarantee that they will receive what they ordered.

Letter of credit

In order to ensure that payment will be received, sometimes exporters will require the importer to have a letter of credit confirmed by a secure bank. A **letter of credit** is a document that a buyer can request from their bank that guarantees the payment of goods will be transferred to the seller. The letter of credit is issued by the importer's bank to the exporter promising to pay them a specified amount once certain conditions have been met. In order for the payment to occur, the seller has to present the bank with the necessary documents proving shipment of the goods.

In all but exceptional circumstances, once the bank has made such a commitment it cannot be withdrawn. In the event that the buyer cannot make the payment, the bank will then be required to cover the purchase. Therefore, the bank will only issue a letter of credit if they know the buyer will pay. Some banks require buyers to deposit or have enough money to cover the payment or else they allow the buyers to use a line of credit.

Only payment in advance offers less risk and, for this reason, a letter of credit is very popular with exporters. This is because it relies on the overseas bank rather than the importer.

BizWORD

*A **letter of credit** is a document that a buyer can request from their bank that guarantees the payment of goods will be transferred to the seller. The letter of credit is issued by the importer's bank to the exporter promising to pay them a specified amount once certain conditions have been met.*

Clean payment

A type of **clean payment** is an open account payment method. Under this method, the exporter ships the goods directly to the importer before payment is received. The importer therefore doesn't send the payment until after they receive the goods. The goods are usually shipped with an invoice requesting payment at a certain time after delivery. This is typically 30, 60 or 90 days. The time the exporter gives the buyer to pay for the goods is called the credit term. This method is usually only used when the exporter is confident that the importer will pay by the agreed time. This method of payment is obviously one of riskiest for exporters; however, it is one of the most advantageous options for an importer.

BizWORD

*A **clean payment** occurs when the exporter ships the goods directly to the importer before payment is received.*

Bills of exchange

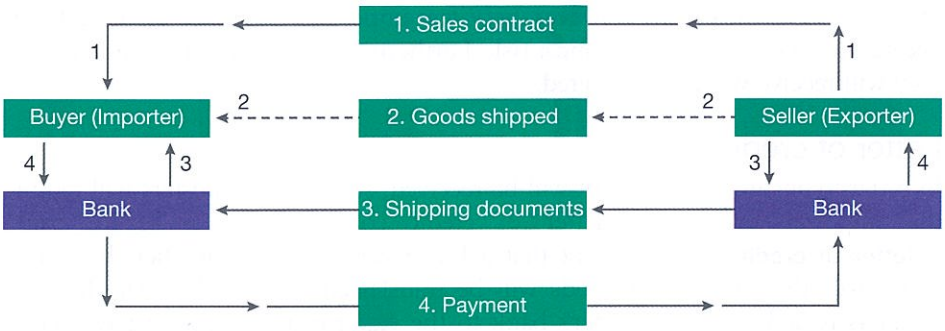
A bill of exchange is a document drawn up by the exporter demanding payment from the importer at a specified time. This method of payment is one of the most widely used and allows the exporter to maintain control over the goods until payment is either made or guaranteed.

There are two types of bill of exchange.

1. *Document (bill) against payment.* Using this method, the importer can collect the goods only *after* paying for them. The exporter draws up a bill of exchange with his or her Australian bank and sends it to the importer's bank along with a set of documents that will allow the importer to collect the goods. The importer's bank hands over the documents only after payment is made. The importer's bank then transfers the funds to the exporter's bank.
2. *Document (bill) against acceptance.* Using this method, the importer may collect the goods *before* paying for them. The same process applies as with documents against payment, except the importer must sign only acceptance of the goods and the terms of the bill of exchange to receive the documents that allow him or her to pay for the goods at a later date.

BizFACT

Countertrade is becoming more popular as a trading or payment system, similar to bartering.



1. Seller and buyer agree terms and enter into a sales/purchase contract.
2. Goods are shipped.
3. Seller presents shipping documents through the banking system. Generally buyers are unable to take delivery of the goods until they have these shipping documents (this does not normally apply to airfreights shipments).
4. Per contracted payment terms, the buyer pays immediately (a 'sight' payment, sometimes known as Docs against Payment — D/P) or formally agrees to pay at a future date (a 'term' payment, sometimes known as Docs against Acceptance — D/A). Upon payment or acceptance documents are released to the buyer to enable them to obtain the goods.

FIGURE 12.14 How bills of exchange work

The risk of non-payment or payment delays when using a bill of exchange is always greater than for a letter of credit. However, documents against acceptance expose the exporter to much greater risk than documents against payment. The risk with documents against payment is that the importer may not collect the documents nor pay for the goods. With documents against acceptance there is the risk the importer may delay payment or not pay at all.

12.5.5 Hedging

When two parties agree to exchange currency and finalise a deal immediately, the transaction is referred to as a spot exchange. Exchange rates determining such 'on-the-spot' transactions are referred to as spot exchange rates. The **spot exchange rate** is the value of one currency in another currency on a particular day. Therefore, when an Australian tourist in Tokyo goes to a bank to convert her dollars into yen, the exchange rate is the spot rate for the day.

Although there are situations when it is necessary to use a spot rate, it may not be the most favourable rate. As explained previously in this section, exchange rates can change constantly. Such currency fluctuations can be a cause of real concern since they can increase costs for businesses and therefore lead to a reduction in profits. However, it is possible for businesses to minimise the risk of currency fluctuations. This process is referred to as **hedging**. Hedging refers to the process of minimising the risk of currency fluctuations to help reduce the level of uncertainty involved with international financial transactions.

BizWORD

*The **spot exchange rate** is the value of one currency in another currency on a particular day.*

BizWORD

***Hedging** is the process of minimising the risk of currency fluctuations.*

BizFACT

Michael Heyman, who runs Roman Camping Equipment, regularly hedges his currency exposure. Heyman sources camping products from overseas to sell in his store for a set price. If he doesn't hedge, some products may end up costing more than the prices he has set, which will mean he ends up losing money. Without hedging, Heyman will not know his costs and this will affect his profit margin.

Natural hedging

A business may adopt a number of strategies to eliminate or minimise the risk of foreign exchange exposure. In this way the business provides itself with a natural hedge. For example, the range of natural hedges adopted by Kohler BioGenetics Limited includes:

- establishing offshore subsidiaries
- arranging for import payments and export receipts denominated in the same foreign currency; therefore, any losses from a movement in the exchange rate will be offset by gains from the other
- implementing marketing strategies that attempt to reduce the price sensitivity of the exported products

- insisting on both import and export contracts denominated in Australian dollars. This effectively transfers the risk to the buyer (importer).

Financial instrument hedging

Apart from such natural hedges there are a growing number of financial products available, called derivatives, that can be used to minimise or spread the risk of exchange rate fluctuations.

12.5.6 Derivatives

To minimise the financial risks involved with exporting, financial institutions are continually developing new types of products, collectively referred to as derivatives. **Derivatives** are simple financial instruments that may be used to lessen the exporting risks associated with currency fluctuations.

To help understand how hedging and derivatives work, it is comparable to having a fixed interest rate on a loan. Since interest rate movements are hard to predict, a fixed rate allows people to lock in a rate on their loan to protect themselves against future interest rate rises. This also helps them plan their finances because they will know exactly how much they will be repaying. The disadvantage is that they won't be able to benefit from falling interest rates if they occur.

Derivatives, if used unwisely, can be as dangerous as the risks against which they are supposed to protect.

The three main derivatives available for exporters include:

- forward exchange contracts
- option contracts
- swap contracts.

BizWORD

Derivatives *are simple financial instruments that may be used to lessen the exporting risks associated with currency fluctuations.*

Forward exchange contract

A **forward exchange contract** is a contract to exchange one currency for another currency at an agreed exchange rate on a future date, usually after a period of 30, 90 or 180 days. This means that the bank guarantees the exporter, within the set time, a fixed rate of exchange for the money generated from the sale of the exported goods.

For example, imagine a business sells $50 000 worth of their products to a Japanese customer, with the invoice payable in 30 days. Derivatives will allow them to lock in the value of that sale by selling Japanese yen and buying Australian dollars for a fixed rate, to be settled at the same time the invoice will be paid, thus locking in the value of the currency.

BizWORD

A **forward exchange contract** *is a contract to exchange one currency for another currency at an agreed exchange rate on a future date, usually after a period of 30, 90 or 180 days.*

BizFACT

Market research shows that many small- to medium-sized exporters hesitate in taking on large deals because of exchange rate concerns. A large order can often put an exporter under great financial pressure, especially if they are unfamiliar with the process of hedging.

Options contract

Foreign currency options provide another strategy for risk management. An **option** gives the buyer (option holder) the right, but not the obligation, to buy or sell foreign currency at some time in the future.

Option holders are protected from unfavourable exchange rate fluctuations, yet maintain the opportunity for gain should exchange rate movements be favourable.

BizWORD

An **option** *gives the buyer (option holder) the right, but not the obligation, to buy or sell foreign currency at some time in the future.*

Swap contract

Since its introduction in the 1980s, swaps have become a very popular financial instrument for businesses wanting to hedge. A **currency swap** is an agreement to exchange currency in the spot market with an agreement to reverse the transaction in the future. It involves a spot sale of one currency together with a forward repurchase of the currency at a specified date in the future; for example, swapping

BizWORD

A **currency swap** *is an agreement to exchange currency in the spot market with an agreement to reverse the transaction in the future.*



FIGURE 12.15 A currency swap contract is a mutual exchange in which the contracting parties agree to exchange cash flows.

$50 million Australian dollars for US dollars now and an agreement to reverse the swap within three months.

Businesses also use currency swaps when they need to raise finance in a currency issued by a country in which they are not well known and are, therefore, forced to pay a higher interest rate than would be available to a better-known borrower or a local business.

For example, a medium-sized Australian business may need Japanese yen, but even though it is a reputable business and has a good credit rating, it may not be well known in Japan. If it can find, or if a broker or bank can team it with, a Japanese business that wants Australian dollars, the swap would work as follows. The Australian business would borrow Australian dollars in Australia, where it is well known and can arrange a loan at cheaper interest rates; the Japanese business would borrow yen in Japan for the same reason. They would then agree to swap the currencies and repay each other's loan; that is, the Japanese business would repay the Australian dollar loan, while the Australian business would repay the Japanese yen loan.

The main advantage of a swap contract is that it allows the business to alter its exposure to exchange fluctuations without discarding the original transaction.

SUMMARY

- Profitability management involves the control of both the business's costs and its revenue.
- Cost controls involve:
  - understanding and monitoring the levels of both fixed and variable costs
  - accounting for and identifying the source and amount of costs through the use of cost centres
  - ensuring that expenses are minimised.
- Revenue controls are also part of profitability management and specifically address policies about a business's marketing objectives, including the sales objectives, sales mix or pricing policy.
- Global financial management refers to strategies that can be adopted to deal with the financial risks and influences on global businesses.
- Fluctuations in the exchange rate create risks for global business. Depreciation and appreciations will impact on both import and export levels and the payments made to overseas businesses or financial intermediaries.
- Domestic and international businesses will source funds internationally and will therefore need to consider the interest rates offered on borrowings. The repayment of this debt must also allow for fluctuations in currency.
- The main methods of international payment include:
  - payment in advance — allows the exporter to receive the payment and then arrange for the goods to be sent
  - letter of credit — a document that a buyer can request from their bank that guarantees the payment of goods will be transferred to the seller. The letter of credit is issued by the importer's bank to the exporter promising to pay them a specified amount once certain conditions have been met
  - clean payment — occurs when the exporter ships the goods directly to the importer before payment is received
  - bill of exchange — a document drawn up by the exporter demanding payment from the importer at a specified time.
- Hedging is the process of minimising the risk of currency fluctuations. Hedging helps reduce the level of uncertainty involved with international financial transactions.
- Derivatives are simple financial instruments that may be used to lessen the exporting risks associated with currency fluctuations.

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Syllabus area 3
Topic 4
Concept 7

Global business management: methods of payment
Summary screen and practice questions

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Syllabus area 3
Topic 4
Concept 8

Global business management: hedging and derivatives
Summary screen and practice questions

EXERCISE 12.3 REVISION

1 **Define** the term 'profitability management'.
2 **Distinguish** between fixed and variable costs.
3 **Why** should a business monitor the levels of both fixed and variable costs?
4 **Outline** the advantage of attributing costs to specific cost centres.
5 **How** can expenses can be minimised?
6 **Recall** the importance of revenue controls in achieving profit maximisation.
7 **Explain** how (a) sales objectives, (b) sales mix and (c) pricing policy can affect the level of profit.
8 **Identify** four factors that make operating globally more complex than operating in a domestic market.
9 **Why** are financial influences often classified as 'uncontrollable'?
10 **Outline** the role played by the foreign exchange market.
11 **Define** the term 'exchange rate'.
12 Using the following exchange rates, **determine** whether the rates (a) to (d), when taken sequentially, show the Australian dollar depreciating or appreciating.
(a) A$1 = US$0.85
(b) A$1 = US$0.70
(c) A$1 = US$0.63
(d) A$1 = US$0.52
13 **Explain** the effect of (a) depreciation and (b) appreciation on the prices of exports and imports.
14 **Outline** how a lack of mutual trust between the exporter and importer may be overcome.
15 Use the following table to **summarise** the four basic methods of payment for exports and how each method works. The first one has been completed for you.

Method of payment	How it works
1. Payment in advance	• Exporter receives payment and then sends goods • No risk for exporter • Few importers use this method
2. Letter of credit	
3. Clean payment	
4. Bill of exchange: (a) against payment (b) against acceptance	

16 **Define** the terms 'spot exchange rate' and 'hedging'.
17 **Propose** three natural hedge strategies a business could implement.
18 An Australian business manager would like to export Ugg boots. However, she is concerned about currency fluctuations. **Discuss** how this risk could be reduced.
19 **Compare** a forward exchange contract, an option contract and a swap contract.

EXERCISE 12.3 EXTENSION

1 Your business enters into a contract to pay a certain amount of foreign currency to someone in six months. Who bears the risk of currency fluctuation? **Explain**.
2 Futures and options are two other types of derivatives. **Investigate** how these two financial instruments help reduce the risk of exporting.
3 Find information online about the services of Westpac Bank.
(a) **Create** a concept map of the services offered to a business in relation to foreign exchange and international business.

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- **Digital doc:** Chapter summary (doc-24814)
- **Interactivity:** Chapter crossword (int-7171)
- **Interactivity:** Multiple choice quiz (int-7172)
- **Weblink:** Westpac Bank

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(b) Locate the currency converter and **determine** the following conversions of Australian dollars to other foreign currencies.

1. A$2.4 million = _____ Fijian dollars
2. A$22.6 million = _____ Swedish kronor
3. A$13.1 million = _____Thai baht

4 **Discuss** some of the issues an Australian business may need to consider when dealing with international trade and currencies.

Finance

MULTIPLE CHOICE QUESTIONS

1. Which of the following are examples of external sources of funds?
   (a) Private equity, overdraft and leasing
   (b) Overdraft, leasing and factoring
   (c) Leasing, factoring and new issues
   (d) Factoring, new issues and mortgage
2. A business has decided to source its finance externally. What would be the main advantage of this?
   (a) It would improve their gearing.
   (b) The interest payments would be tax deductible.
   (c) It would be cheaper than other sources of finance.
   (d) It would result in less risk for the owner and the business.
3. Which ratio can be used to measure a business's efficiency?
   (a) Current ratio
   (b) Expense ratio
   (c) Debt to equity ratio
   (d) Return on equity ratio
4. Which of the following strategies could be used to manage working capital?
   (a) Leasing and factoring
   (b) Factoring and selling
   (c) Leasing and marketing
   (d) Inventory control and selling
5. Which of the following are important aspects of financial planning and implementing?
   (a) Developing budgets and financial controls
   (b) Financial controls and account management
   (c) Account management and maintaining record systems
   (d) Maintaining record systems and staff management
6. What is an advantage of equity?
   (a) Dividends must be paid.
   (b) There is a lower level of gearing.
   (c) Regular repayments must be made.
   (d) Interest payments are tax deductible.
7. Which of the following indicates the effectiveness of a firm's credit policy?
   (a) Expense ratio
   (b) Current ratio
   (c) Net profit ratio
   (d) Accounts receivable turnover ratio
8. Refer to the following information.

Financial information for Bella Pty Ltd

	$ million
Sales	650
Cost of goods sold	45
Expenses	470

Calculate the net profit ratio.
(a) 21%
(b) 35%
(c) 72%
(d) 93%

9. Which method of international payment represents the least risk for an exporter?
   (a) Clean payment
   (b) Letter of credit
   (c) Bill of exchange
   (d) Payment in advance
10. Which of the following would be an advantage of hedging?
   (a) It allows businesses to export more easily.
   (b) It increases a business's access to foreign markets.
   (c) It allows businesses to increase the use of derivatives to expand.
   (d) It decreases the financial risk associated with currency exchanges.

SHORT RESPONSE QUESTIONS

1. The debt to equity ratio of Pantry Plus is currently at 0.44:1.
   (a) **Outline** what is meant by debt to equity ratio. *4 marks*
   (b) **Recommend** strategies that could be implemented by Pantry Plus to address this situation and **justify** your recommendations. *8 marks*
2. Georgia has decided to open a fashion and makeup business that caters for girls/women with a specific focus on tweens, teens and early twenties. She is currently creating her business plan and must now make financial decisions about her business.
   (a) **Propose** three sources of finance relevant to her business. *3 marks*
   (b) **Identify** and **explain** the role of the government in her financial management considerations. *6 marks*
   (c) **Analyse** the financial risk factors in long-term external finance for Georgia. *10 marks*
3. Slickwheels Pty Ltd is a medium-sized Australian business that specialises in the production of skateboards. Slickwheels is experiencing difficulties in relation to working capital management.
   (a) **Define** the term 'working capital'. *2 marks*
   (b) **Explain** *one* control of current assets and *one* control of current liabilities that could be implemented immediately to assist financially. *4 marks*
   (c) **Propose** *one* working capital strategy that may assist the business to manage this financial situation effectively. *4 marks*
4. Refer to the following balance sheet.

	$	$
Current Assets		
Cash	7 000	
Receivables	6 000	
Inventories	2 000	15 000
Non-current Assets		
Property, plant and equipment		18 000
Total Assets		33 000
Current		
Liabilities		14 000
Creditors		
Net Assets		19 000
Owners' Equity		
Capital	16 500	
Net Profit	2 500	19 000

(a) **Calculate** the current ratio of this business. *4 marks*
(b) **Propose** two strategies that could be used to manage its current ratio. *4 marks*
(c) **Assess** how an overdraft of $2000 would affect the current ratio. *8 marks*

5. 'The Australian dollar has risen to a yearly high of US$1.10. Only six months ago it was trading at 85.4 US cents.'
(a) **Define** the term 'exchange rate'. *2 marks*
(b) **Demonstrate** the main risks to an Australian exporting business of excessive fluctuations in exchange rates. *6 marks*
(c) **Evaluate** two strategies a business can implement to help minimise the risk of exchange rate fluctuations. *10 marks*

EXTENDED RESPONSE QUESTIONS

1. A high debt to equity ratio financed by both short-term and long-term borrowing has led to a decision by a firm to downsize its operations. **Discuss** the effects of such a decision on stakeholders in the business.
2. The following have been identified by management:
   - difficulties in matching cash inflows with outflows
   - declining liquidity
   - declining accounts receivable turn over and expense ratios.

   Management is considering a wider use of technology in its interactions with markets. Write a report to management **recommending** a range of strategies to improve the position of the business.
3. Wax and Wayne is an Australian (private) company that manufactures retro and custom-made surf boards. The company has always been focused on the domestic market but with the increasing worldwide profile of surfing and an expansion in the demographic of the sport they have decided to (slowly) expand into the South East Asian market. This first stage of expansion will require a substantial financial commitment. Write a report to the management of Wax and Wayne **determining** the financial aspects of the company that need to be considered in making this decision.
4. A business decides to undervalue its inventories and debtors to indicate favourable liquidity and thus better short-term financial stability of the business. **Outline** the advantages and disadvantages of this decision and **assess** its ethical implications.
5. Verada Constructions Limited is an Australian public company specialising in commercial property development. Verada wants to expand its operations by diversifying into residential property development. It is estimated that, to achieve this goal, it will require $85 million of additional finance. Write a report to the management **outlining** the internal and external sources of finance available for such a project. **Determine** which source you consider to be the most appropriate. **Justify** your selection.

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