Finance for Non-Finance Managers

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27th August 2026

Topic 1: Accounting principles and financial reporting

What are Accounts?:

-A summary of the business financial activities for a period of time – usually 12 months.

-Also referred to as financial statements

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Business Financial Activity (Transactions):

It is very important that a business has a system to record and monitor their financial transactions.

Business transactions are the foundation and source of all reporting.

It is essential that this information is accurate, complete and up to date to ensure the financial status of the business reported is accurate.

The system adopted needs to be able to record transactions in a manner that will provide management with the information required for decision making purposes.

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Business Financial Activity (Transactions):

Double entry Bookkeeping is the basis for recording and reporting financial transactions.

Bookkeeping involves the recording an organisation’s financial transactions.

This enables organisations track all information on its books to make key financing decisions.

Bookkeepers are individuals who manage the financial information for organisations.

Without a bookkeeping function, organisations would unaware of their current financial position, as well as the transactions that occur within the business.

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Business Financial Activity (Transactions):

Ledger accounts are used to generate a list of balances on all accounts : the trial balance.

The financial statements are produced using the trial balance.

This means the figures reported in the financial statements can be traced back to the ledger accounts in the trial balance and ultimately to the individual transactions in the books of prime entry.

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The Role of Financial Accounting:

The finance function of an organisation fulfils the following roles:

Summarising Figures
Captures and records financial transactions
Summarises these transactions to report the financial performance of the business

Focusing Attention
Highlights important details from the financial reports
Identifies trends contained in the reports
Facilitates comparison with previous reporting periods and other businesses

Problem solving
Assist with the optimum choice from options available to ensure a successful decision is made

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Planning and Forecasting:
Establish organisational objectives
Determining strategies to achieve these objectives
Reporting on anticipated future results with these objectives as the focus

Decision Making
Improve decision making through the reporting structure
Facilitates the use of financial reporting to enhance making decisions
Providing consistency with overall objectives

Control
Monitors and review performance
Provide options to help improve performance in relation to business plans
Where necessary, used to modify plans

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The Finance Department:

This department is responsible for:

- Financial Accounting
- Management Accounting
- Payroll Administration
- Credit Control / Accounts Receivable
- Accounts Payable
- Treasury Management
- Financial Strategy
- Taxation
- Internal Audit

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The Finance Department:

The Accountant in a business is the individual or group of individuals who carry out the tasks of the finance functions

They have a wide variety of responsibilities in controlling the finance of a business, including:

- Data collection
- Data entry
- Reporting
- Budgeting
- Forecasting
- Cash Management
- Strategic investment management

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The Finance Department:

Depending on the size of the business, the finance department may have a number of layers of management.

Typically, the Chief Financial Officer (CFO) is the head of this function, and they work closely with the CEO and Board of Directors in implementing strategic decisions.

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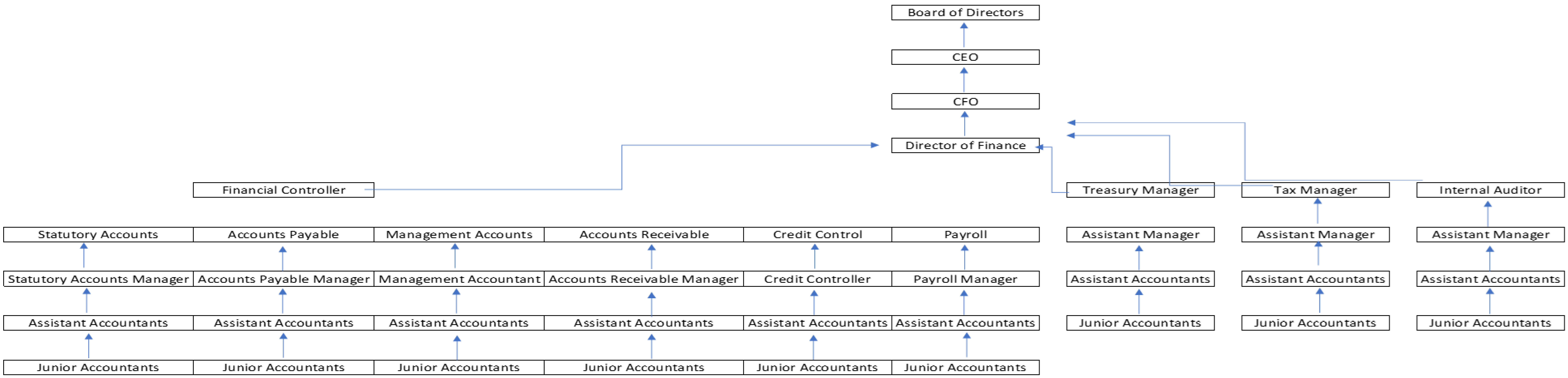

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Legislation states that directors report financial information to the owners (shareholders)

This is done through the Annual Report and Financial Statements, comprising of four key documents:

- Statement of Comprehensive Income (Profit and Loss Account)
- Statement of Financial Position (Balance Sheet)
- Statement of Changes in Equity
- Statement of Cash Flows

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Financial Statements are regulated by legislation (in Ireland, the Companies Act 2014)

Sections 281–285 obliges every company to maintain ‘adequate accounting records’

Section347 sets out documents to be attached to annual return, put before members at Annual General Meeting and sent to Companies Registration Office:

Financial Statements already mentioned plus:
Directors’ Report
Statutory Auditor’s Report

The act also describes the format the financial statements should take

Topic 1: Accounting principles and financial reporting

The financial statements are also governed by accounting Principles and Standards

There are broadly two separate systems:
GAAP (Generally Accepted Accounting Principles)
IFRS (International Financial Reporting Standards)

GAAP is a rules-based system whereas IFRS is a principles-based system.

IFRS allows more latitude for interpretation

IFRS has been adopted in over 144 countries

GAAP is only used predominantly in the USA

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The Conceptual Framework for Financial Reporting provides guidance around preparation of financial statements.

A conceptual framework is an attempt to define the nature and purpose of accounting.

Conceptual frameworks can apply to many disciplines, but when specifically related to financial reporting, a conceptual framework can be seen as a statement of generally accepted accounting principles that form a frame of reference for the evaluation of existing practices and the development of new ones.

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The International Accounting Standards Board IASB Conceptual Framework for Financial Reporting (original framework 1989, updated 2010 and 2018):

Purpose
Assist in development of future IFRS
Promote harmonisation of accounting regulation and standards
Assist the preparers of financial statements in the application of IFRS
Assist national standard setting bodies in developing national standards
Assist auditors in forming opinion whether financial statements comply with IFRS

The development of the framework has led to the IASB producing world-class financial reporting standards (IFRS) which are widely accepted, produced with international co-operation, comparable, used for consolidation and listing requirements. (www.ifrs.org)

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As part of the Framework, there are two broad characteristics of financial Information:

Fundamental qualitative characteristics
To be useful to users, information must possess certain qualities
These qualities are regarded as fundamental:
Relevance
Faithful representation

Enhancing qualitative characteristics:
Where information is relevant and faithful, there are other qualities that enhance its usefulness:
Comparability
Verifiability
Timeliness
Understandability

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For financial information to be useful, the audience at which it is aimed needs to be identified.

There will always be a number of users who have in interest in the financial information of the organisation.

These users will require information in order to make decisions in relation to the organisation in question.

There is always the possibility that the requirements of one group will conflict with those of another.

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Management Accounting and Financial Accounting:

Financial or statutory accounting is designed to meet the needs of external users of financial information.

Financial information prepared and presented in this way demonstrates a business's accountability to shareholders using financial reporting principles and standards.

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Management Accounting and Financial Accounting:

Management accounting are prepared to satisfy the needs of managers.

Management reports often include:
- Specific-purpose reports.
- Designed for a particular decision.
- Presented for an individual manager.

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Management Accounting and Financial Accounting:

Management reporting differs from financial reporting :

- Information is not usually aggregated.
- There are no external regulations that apply to their format or content.
- Designed with the needs of particular managers in mind.
- Management reports are more forward by nature looking than financial reports.
- They seek to provide managers with information to aid decision making about the future.

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Management Accounting and Financial Accounting:

Management accounts provide financial information similar to financial reports, but often include non-financial information e.g.

- Physical volumes of inventory.
- Number of sales orders received.
- New products launched.
- Number of employees.

Financial accounting seeks to be objective and appeal to a wide external audience; management accounting uses information that is less objective and provides managers with information for decision making.

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Management Accounting and Financial Accounting:

Management accounting looks at a wide range of sources and may use information with various degrees of reliability.

The essence of the value of management accounting is whether it improves the quality of the decisions made by managers.

Managers have more control over the form and content of the information they receive due to the access of more detailed information.

Although quite extensive, external users must rely on the information financial regulations decide they can have.

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Evaluating a Company's Performance:

Budgeting:

- A detailed plan that sets out, in money terms, plans for income and expenditure in a future period.
- Prepared in advance, based on agreed objectives and strategy.
- Start with SALES budget, build up MASTER budget.
- Facilitates control, provides a target for comparison.

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Evaluating a Company's Performance:

The Purpose of Budgets:

- Planning
- Control
- Coordination
- Motivation
- Communication
- Performance evaluation

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Evaluating a Company's Performance:

Planning:

- Business planning is a way of managing time, and of anticipating the future.
- Business forecasting is an integral part of this planning process.
- Forecasting is an attempt to illustrate how a market or another external environmental variables will behave during the planning period based on assumptions.
- There are a variety of forecasting approaches, techniques and method.
- The effectiveness of the planning process may be dependent on the process of business forecasting employed.

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Evaluating a Company's Performance:

Why do we need Planning and Forecasting?

- It is unacceptable for an enterprise to be responsive only to its present environment (reactive).
- All businesses needs to plan for the future in a proactive manner.
- Management anticipate the future environments within which the organisation will operate.

Topic 1: Accounting principles and financial reporting

Evaluating a Company's Performance:

Control:

- Control is the process of ensuring that events conform to plans.
- Senior managers can monitor performance against a defined plan and will understand the process better.
- This enables management to review exceptions and means only those activities that are failing need to be reviewed.

Topic 1: Accounting principles and financial reporting

Evaluating a Company's Performance:

Coordination:

- Activities of the different parts of an organisation must work together to achieve the strategic aims of the business.
- Budgeting assists in achieving this focus on coordination.
- Budgeting ensures that no one division is out of line with another.
- Failure to do so may result in disruption from inefficiencies.

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Evaluating a Company’s Performance:

Motivation:

- Managers involved in the preparation of budgets are more likely to be motived to achieving the objectives of the budget.
- Stated tasks can motivate individuals in the achievement of them.
- Another role of budgeting is to influence attitudes and behaviours of managers
- Budgets can improve job satisfaction - often achieved through creating structure and stability.
- Challenging but achievable budgets tend to provide better motivation.
- Unrealistic budgets tends to have the opposite effect.
- Managers foster a sense of ownership and therefore commitment to the objectives.

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Evaluating a Company's Performance:

Performance Evaluation:

- A budget is also a useful tool for evaluating performance.
- Where targets are achieved or performance in relation to expenditure is reasonable, then incentives are paid.
- Management should and ensure that budgetary slack does not occur wherever possible through effective use of budgets.
- Budgetary slack is the difference between the minimum necessary costs and the costs built into budget or actually incurred.

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End of Section Questions 1:

(a) What are accounts?

(b) Why are they prepared?

(c) What types of transactions are undertaken by a business?

(d) Is it possible for accounting information to possess all aspects of faithful representation?

- Complete
- Neutral
- Free from Error

(e) Should accounting reports be understandable to those who have not studied accounting?

Coffee Break

Topic 2: Understanding the key Financial Statements:

Company Accounts:

National legislation through the likes of the companies acts in Ireland dictate the minimum accounting records which must be maintained by a company.

They may also contain detailed requirements on the minimum information which must be disclosed.

This generally applies to companies with limited liability. Different rules apply to unlimited companies.

The owners of a company may be numerous.

Topic 2: Understanding the key Financial Statements:

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Company Accounts:

The owners' (shareholders) capital in a limited liability company consists of Share Capital.

When a company is set up at first it issues shares which are paid for by investors who then become shareholders of the company.

Shares are denominated in units of 25c, 50c, €1 or whichever seem appropriate. The face value is known as the par value, legal value or nominal value.

Topic 2: Understanding the key Financial Statements:

Company Accounts:

The International Financial Reporting Standard IAS 1 prescribes the basis for presentation of financial statements, to ensure comparability both with the entity's financial statements of previous periods and with the financial statements of other entities.

Topic 2: Understanding the key Financial Statements:

Company Accounts:

Components of financial statements

- A statement of financial position (balance sheet) at the end of the period.
- A statement of profit or loss and other comprehensive income for the period.
- A statement of changes in equity for the period.
- A statement of cash flows for the period.
- Notes, comprising a summary of significant accounting policies and other explanatory notes.
- Comparative information prescribed by the standard.

Topic 2: Understanding the key Financial Statements:

Financial Statements:

(1) The Statement of Profit or Loss And Other Comprehensive Income (alternatively known as the Income Statement or the Trading Profit and Loss Account).

This Statement details how the Profit or Loss of a particular period was made. There are two main components of this statement:

- The Trading Account
- The Profit and Loss Account

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P Price Ltd. Statement of Profit or Loss and Other Comprehensive Income for the year ended 31 December 2022

	€	€
Revenue		180,500
Cost of Sales		
Purchases	89,200	
Opening Stock	32,000	
Carriage	7,700	
Purchases Returns	-5,000	
Closing Stock	-40,500	
Total Cost of Sales		83,400
Gross Profit		97,100
Expenses		
Wages and Salaries	39,800	
Electricity	5,100	
Advertising	4,000	
Insurance	5,450	
Bad Debts	1,000	
Rent and Rates	7,500	
Depreciation	22,000	
Total Expenses		84,850
Net Profit before interest and tax		12,250
Interest		2,500
Taxation		5,000
Net Profit after Tax		4,750

Topic 2: Understanding the key Financial Statements:

Financial Statements:

The trading account shows the Gross Profit for the period.

- The gross profit is the difference between Sales Revenue and the cost of goods sold i.e. the cost of sales (as calculated under the matching principle).
- Where a firm sells product, the sale and delivery of that product means the revenue can be recognised.
- While this might seem straight forward, sales revenue can present difficulties in terms of determining when to recognise the revenue, and in calculating the cost of goods sold on the accruals basis of accounting.

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Financial Statements:

The cost of goods sold in the trading account is calculated in a particular way.

This takes into account:

- Goods purchased for resale
- Goods sold through from inventory
- And any closing inventory
- All Other Direct Costs of Selling

Topic 2: Understanding the key Financial Statements:

Financial Statements:

The bottom half of the income statement includes operating expenses and income from other sources.

Operating expenses include such things as:

- Salaries and wages
- Rent and Rates
- Travelling Expenses
- Marketing Costs
- Interest
- Depreciation and Amortisation

Essentially it includes any cost associated with running the business that is not directly associated with sales

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Financial Statements:

(2) The Statement of Financial Position is a snapshot of the financial position of a firm at one point in time.

It presents a list of assets and liabilities at a single point in time.

Included in the statement are:
- The assets owned by the company
- The liabilities owed by the company

In general, the statement is divided along these lines and the assets section should balance with the liabilities section

Topic 2: Understanding the key Financial Statements:

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P Price Ltd. Statement of Financial Position as at 31 December 2022

Non-Current Assets		
Fixtures		48,000
Motor Vehicles		30,000
Total Fixed Assets		78,000
Current Assets		
Debtors	30,000	
Closing Stock	40,500	
Bank	15,000	
Prepayments	650	
		86,150
Total Assets		164,150
Current Liabilities		
Creditors	37,500	
Provision for Taxation	5,000	
Accruals	6,900	
		49,400
Non-Current Liabilities		
Loan Notes		25,000
Total Laibilities		74,400
Net Assets		89,750
Equity and Reserves		
Share Capital		10,000
Share Premium		25,000
Retained Profits		54,750
Total Capital		89,750

Topic 2: Understanding the key Financial Statements:

Financial Statements:

The top half of a Statement of Financial Position includes the assets owned by the firm and are analysed by:

Non-Current Assets, these are assets that:

- Have a long life
- Are acquired for use within the business
- Are not purchased for resale

Topic 2: Understanding the key Financial Statements:

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Financial Statements:

Non-current assets can be subdivided into three main categories:
- Tangible non-current assets
- Intangible non-current assets
- Financial non-current assets

An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity (IASB Framework).

Topic 2: Understanding the key Financial Statements:

Financial Statements:

Tangible non-current assets are the most readily recognisable and include:
- Plant and Machinery
- Office Equipment
- Motor Cars

Intangible non-current assets include:
- Licenses
- Copyright
- Trademarks
- Goodwill

Topic 2: Understanding the key Financial Statements:

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Financial Statements:

Financial non-current assets include:
- Investments
- Loans to other entities.

Topic 2: Understanding the key Financial Statements:

Financial Statements:

The top half of a statement of financial position also includes current assets and this class of assets typically includes:

- Inventory
- Debtors and Prepayments
- Cash at Bank and in Hand

The amounts disclosed under these headings are usually aggregated, but where this is the case, they are generally explained with an analysis of the breakdown in the notes to the accounts

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Financial Statements:

The bottom half of a statement of financial position includes the liabilities owed by the firm to outside entities and again are analysed by Non-Current and Current.

Non-current Liabilities, generally liabilities payable after more than one year, for example:

- Debentures
- Long Term Loans
- Commercial Mortgages

Topic 2: Understanding the key Financial Statements:

Financial Statements:

Current Liabilities, usually payable within one year

- Trade Payables
- Accruals
- Overdrafts

A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits (IASB Framework).

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Financial Statements:

The final part of the Statement of Financial Position is capital and reserves.

This section includes:

- Called up share capital
- Any reserves available e.g. profits carried forward from prior years and any reserve arising from the revaluation of non-current assets
- Profit or loss in the current year

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Topic 2: Understanding the key Financial Statements:

Financial Statements:

(3) The statement of Changes in Equity documents the changes to capital and reserves and seeks to explain how these changes arose.

It reconciles capital and reserves at the beginning of the reporting period with those at the end of the reporting period.

The statement of Changes in Equity documents the changes to capital and reserves and seeks to explain how these changes arose.

It reconciles capital and reserves at the beginning of the reporting period with those at the end of the reporting period.

Topic 2: Understanding the key Financial Statements:

Financial Statements:

The statement of Changes in Equity shows the effect on capital and reserves of :

- Total comprehensive income (Profit and Loss)
- Share issues and purchases
- Dividends
- Changes to reserves

Topic 2: Understanding the key Financial Statements:

Financial Statements:

(4) Statements of Cash Flow:

The Statement of Profit or Loss and Other Comprehensive Income and the Statement of Financial Position are prepared using the accruals basis of accounting.

The Statement of Cash Flows uses the facts in relation to the inflow and outflows of cash in the business.

For example, if a business bought 100 footballs for €3 each and sold them for €10 each on credit it would report a healthy profit of €700 under the accruals method of accounting. But from a cash perspective, there would be a net outflow of €300 until the cash is received from the credit customer.

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Financial Statements:

The Statement of Cash Flow is constructed using the Statement of Profit or Loss and Other Comprehensive Income and the Statement of Financial Position for an accounting period.

The cash information is derived when analysing these Statements.

Topic 2: Understanding the key Financial Statements:

Financial Statements:

Format:

As prescribed in IAS 7 Statement of Cash Flows, cash flows are categorised under one of three headings:

- Cash Flows from Operating Activities
- Cash Flows from Investing Activities
- Cash Flows from Financing Activities

Topic 2: Understanding the key Financial Statements:

P Price Ltd. Statement of Cash Flows as at 31 December 2022

1) Cash Flows from Operating Activities:		
Net Profit Before tax	9,750	
Add: Depreciation	22,000	
Movement in Trade Receivables	-25,000	
Movement in Inventories	-12,000	
Movement in Trade Payables	19,500	
Total Cash Flows from Operating Activities		14,250
2) Cash Flows from Investing Activities		
Fixtures	-27,500	
Motor Vehicles	-12,000	
Total Cash Flows from Investing Activities		-39,500
3) Cash Flows from Financing Activities		
Share Issue	12,500	
Bank Loan	17,500	
Total Cash Flows from Financing Activities		30,000
Net Cash Flows		**4,750**
Opening Bank Balance		***10,250***
Closing Bank Balance		***15,000***
Movement in Cash / Cash Equivalents		***4,750***

Topic 2: Understanding the key Financial Statements:

Financial Statements:

Cash refers to cash available on demand, net of any overdraft.

Cash equivalents are short-term, highly liquid investments which:

- Are easily convertible into a known quantity of cash.
- Have little of no risk of change in value.

The overall movement in cash and cash equivalents in a given period is reflected in more detail in the Statement of Cash Flow

Topic 2: Understanding the key Financial Statements:

Financial Statements:

Producing the Statement of Cash Flow:

The statement of Cash flow for a period can be derived from the following information:

A Statement of Financial Position at the start of the period
A Statement of Financial Position at the end of the period
A Statement of Profit or Loss for the period

Topic 2: Understanding the key Financial Statements:

Financial Statements:

Cash Flows from Operating Activities takes the profit from operations derived by adjusting the profit before tax for finance costs and investment income and then adjusting for:

Non-cash expenses and income (e.g. depreciation, profit / loss on disposal of non-current asset). This is a non-cash expense / income that reduces or increase net income to reflect this fact.

The effects of accrual accounting (e.g. changes between the opening and closing balances on the inventory, receivables and payables).

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Financial Statements:

Cash Flows from Investing Activities looks at the cash movement in the Non-Current assets section of the Statement of Financial Position.

It represents:

- Payments to acquire Non-Current Assets.
- Proceeds from the sale of Non-Current Assets.

As many statements of financial position state, the carrying value of the non-current assets, the split between cost and accumulated depreciation is not given.

Topic 2: Understanding the key Financial Statements:

Financial Statements:

Cash Flows from Financing Activities:

Proceeds from the issue of shares is calculated by comparing the opening and closing balances for Share Capital and Share Premium:

Share Capital + share Premium at end of the year	X
Share Capital + share Premium at beginning of the year	(X)
Cash Raised from share issues	X

Topic 2: Understanding the key Financial Statements:

Financial Statements:

Cash Flows from Financing Activities:

Proceeds from long term borrowings / redemption of borrowings:

Again, cash transactions relating to long term borrowings can be calculated with reference to the opening and closing balances on these accounts.

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Financial Statements:

(5) Notes have an important role in the presentation of financial statements:

They help the user understand the contents of the financial reports.

The financial statements are usually aggregated and the notes to the statements can show the details behind the numbers.

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Financial Statements:

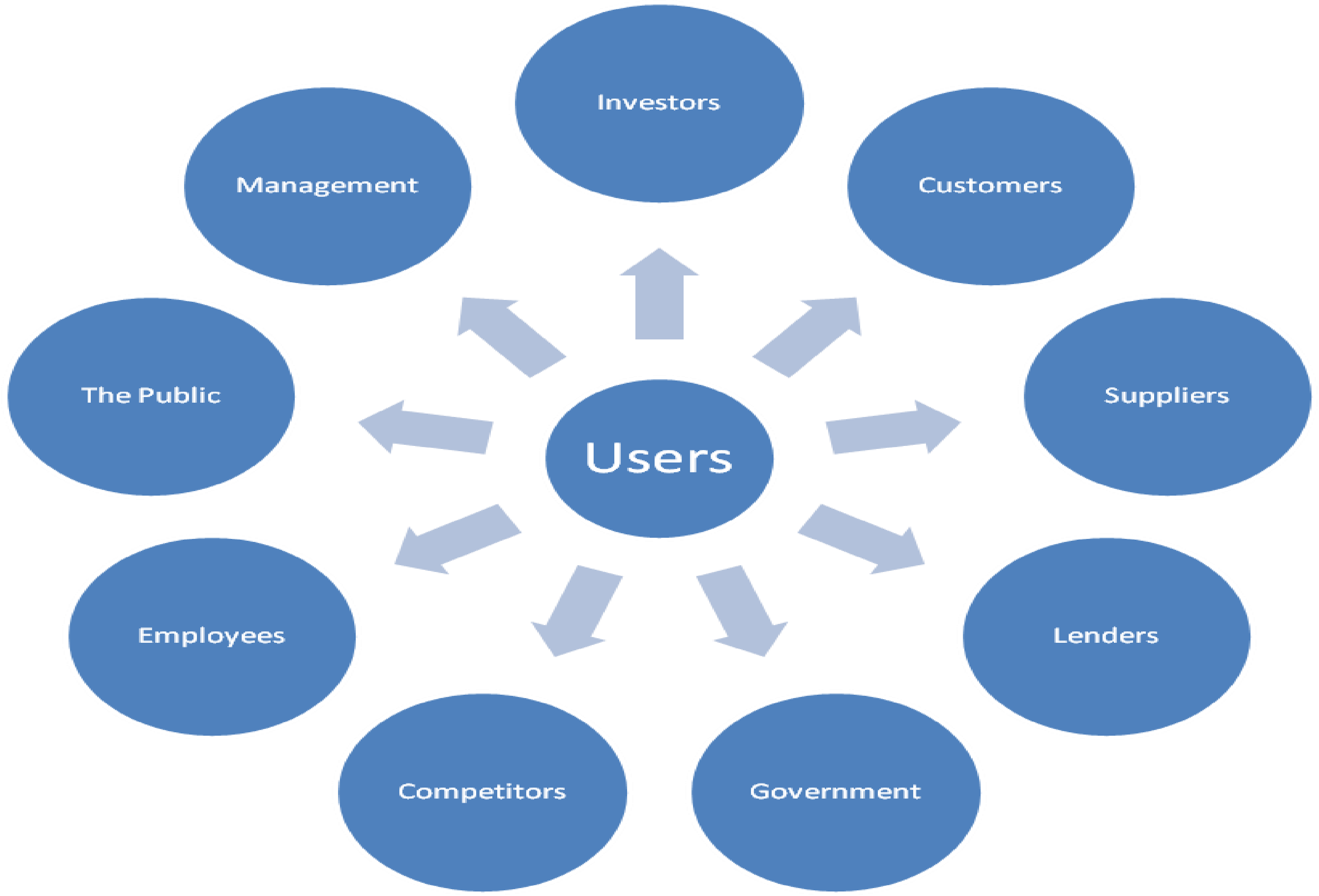
Notes to accounts typically contain:

- Confirmation that the financial statements comply with the relevant standards
- A summary of the basis of measurement used
- Any significant accounting policies applies e.g. valuation of inventories, Depreciation policy etc
- Supporting information relating to items appearing on the statements e.g. breakdown of current liabilities
- Any other significant disclosures e.g. future contractual commitments not recognised in the financial statements

Topic 2: Understanding the key Financial Statements:

End of Section Questions 1:

Global PCs is a multinational manufacturer of computer hardware based in Ireland. What factors might need to take into account in decisions made in relation to the firm when using the Financial Statements:



Topic 2: Understanding the key Financial Statements:

End of Section Questions 2:

(a) Why is the Statement of Cash Flows important for the users of financial statements in making decisions about a company?

(b) If there is a difference between the net profit of a business and the cash flows from operating activities, what does this indicate?

(c) What is the relationship between cash generated from investing activities and those generated from financing activities?

Coffee Break

Topic 3: Working Capital Management:

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Introduction:

Working capital relates to the management of short term assets in the business.

These usually relate to those assets that are expected to be realised within 12 Months.

It is also taken as a business's liquidity i.e. its ability to pay its debts as they fall due.

Working capital represents a significant investment for most businesses and may even exceed the investment non-current assets.

It is vital that they are carefully managed.

Topic 3: Working Capital Management:

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Introduction:

The major elements of current assets are inventories , trade receivables and cash - both in hand and at bank.

The major elements of current liabilities are trade payables and bank overdrafts.

Correctly defining working capital can be a challenge and issues to address are:

- What constitutes a current asset?
- What constitutes a current liability?
- How are individual components of working capital measured?
- How is the liquidity distinguished from net current assets?

Topic 3: Working Capital Management:

Introduction:

Current assets include factors such as prepayments and bad debt provisions as well as Other' debtors.

A provision is not something that can be converted into cash, it is only an accounting adjustment.

Prepayments are usually expenses paid in cash, but the expense for the period is less than the cash paid and a prepayment is raised to defer the excess expense to a later more appropriate period.

Current liabilities too can be distorted by accruals and deferred income.

Topic 3: Working Capital Management:

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Introduction:

The size and composition of working capital can vary between businesses and industry sectors.

For example, Manufacturing businesses often invest heavily in raw material, work in progress, and finished goods.

It would normally day-to-day its goods on credit giving rise to large trade receivables.

Raw materials would be bought on credit giving rise to a high level of trade payables.

Topic 3: Working Capital Management:

Introduction:

Other businesses such as retailers may only hold one form of inventories and normally it would sell its goods for cash rather than credit.

Working capital represents a net investment in short term assets.

These assets are continually flowing in and out of the business and are essential for day-to-day operations.

Topic 3: Working Capital Management:

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Working Capital Cycle:

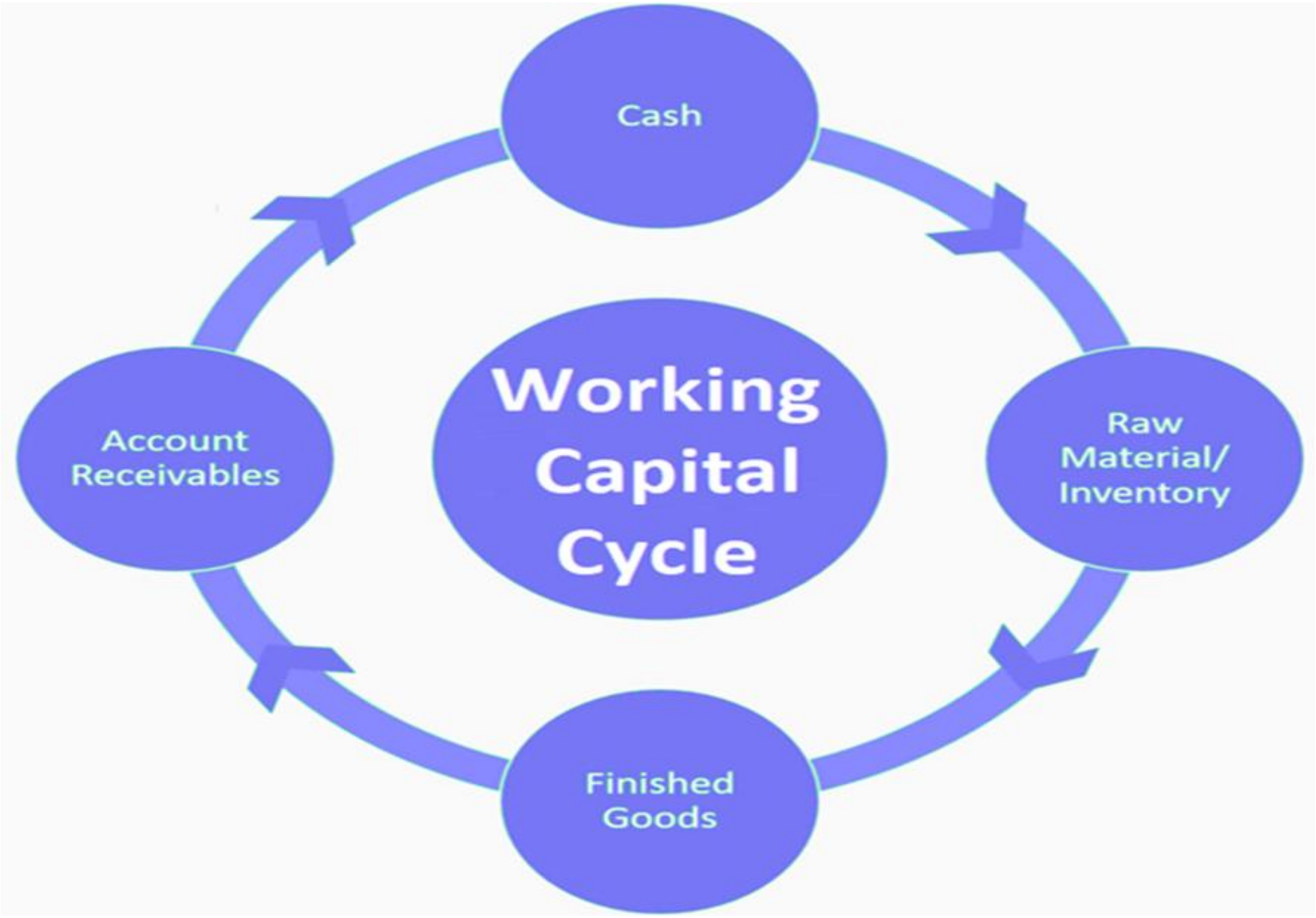
The working capital cycle (often referred to as the ‘Operating’ or the ‘Cash Cycle’)   indicates the process of turning raw materials back into cash via receivables and payables.

The length of this cycle is significant in determining the level a working capital investment required in a business.

The different elements of working capital are connected giving rise to the term ‘Working Capital Cycle.’

Topic 3: Working Capital Management:

Working Capital Cycle:



Topic 3: Working Capital Management:

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Working Capital Cycle:

The working capital cycle is often expressed as a period of time i.e. how long it takes to turn raw materials back into cash.

This is calculated by using a number of Working Capital ratios :

Average Debtor Days + Average Inventory Days – Average Payable Days = Working Capital Cycle.

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Working Capital Cycle:

There is no rule to benchmark for the optimal cycle.

Businesses tend to focus on individual components of working capital rather than the whole cycle.

Making comparisons with prior periods or benchmarking with competitors may indicate where improvements can be made.

Topic 3: Working Capital Management:

Working Capital Cycle:

(1) Average Debtor Days:

Shows how long, on average, it takes for customers to pay.

Receivable Days - Calculated as follows:

$$\frac{\text{Receivables}}{\text{Revenue}} \times 365 \text{ days}$$

The result should be in line with the credit policy of the company. In many cases this is 30 days, but this may vary depending on the industry and the relationship with certain customers.

An increase in receivable days not explained by an increase in credit period offered may indicate a poor credit control function in the company and may indicate irrecoverable debts.

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Working Capital Cycle:

(1) Average Debtor Days:

Group sales may skew the figures as they may have extended periods of credit and levels may fluctuate due to timing issues.

A decrease in receivable days not explained by a change in credit period offered may indicate credit control are chasing debts.

This may be detrimental in the long run if too aggressive. Another explanation may be early payment discounts offered.

Topic 3: Working Capital Management:

Working Capital Cycle:

(2) Inventory Days:

Inventory days show how long, on average, inventory is held by a company before it is sold. It is calculated as follows:

$$\frac{\text{Inventory}}{\text{Cost of Sales}} \times 365 \text{ days}$$

Appropriate levels depend on the industry.

Topic 3: Working Capital Management:

Working Capital Cycle:

(2) Inventory Days:

An increase in inventory days may be explained by a company stocking up prior to a large order or an arrangement with a customer to hold goods on their behalf. It may also indicate a fall in demand or obsolete stock.

A decrease in inventory days may be explained by a new policy to reduce the level of inventory held to reduce the costs associated with this such as storage and insurance. It may also indicate supply problems and possible stock outs in which case orders may not be met and a detrimental effect on the company’s reputation.

Topic 3: Working Capital Management:

Working Capital Cycle:

(3) Payable Days:

Show how long on average it takes a company to pay its credit suppliers.

Calculated as follows:

$$\frac{\text{Payables}}{\text{Cost of Sales}} \times 365 \text{ days}$$

The result should be the credit period extended to the company.

Topic 3: Working Capital Management:

Working Capital Cycle:

(3) Payable Days:

An increase not explained by an increased period of credit offered indicates slower payment of suppliers. This may cause problems with the relationship with the supplier. And in extreme cases lead to the liquidation of the company.

A decrease without a corresponding decrease in credit terms may indicate the company is paying earlier to take advantage of early payment discounts. Alternatively, it may indicate poor working capital management as payables are a source of free finance.

Topic 3: Working Capital Management:

Working Capital Cycle:

(4) Cash:

To manage cash effectively, it is useful to prepare a cash budget.

This is an important tool for planning and control purposes.

Cash budgets enable managers to monitor how planned events will affect cash flow e.g. expansion of the sales force, extending credit terms.

The key usefulness of a cash budget is in identifying when there will be cash surpluses or deficits.

Where a cash surplus is expected to arise, managers must decide on the best use of the surplus funds.

Topic 3: Working Capital Management:

Working Capital Cycle:

(4) Cash:

Where cash deficits are anticipated managers must deal with this by making provision for adequate borrowing e.g. an overdraft.

Liquidating short term assets.

Rescheduling cash payments or receipts.

Every company large or small will at some point create a cash budget.

Budgets in general tend to be for internal use only and the format is therefore decided by management.

Topic 3: Working Capital Management:

Working Capital Cycle:

(4) Cash:

In most businesses a cash budget will generally include:

The budget period broken down into smaller periods e.g. a year represented in months.

- Columnar format with one column per month.
- Receipts listed under different headings with a total of all receipts shown.
- Payments listed under different headings with a total of all payments shown.
- The surplus of receipts over payments or payments over receipts would be shown.
- A running cash balance.

Topic 3: Working Capital Management:

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Working Capital Cycle:

(4) Cash:

The cash budget is arrived at by a prediction of future cash receipts and payments. It reveals the timing and amount of expected cash inflows and outflows over time. Armed with this information a manager is in a better position to forecast the future cash needs of the business by:

- Planning to finance cash deficits.
- Prepare to invest short term surpluses.
- Ensure sufficient liquidity to attend to the day to day needs of the business.

Topic 3: Working Capital Management:

Working Capital Cycle:

(4) Cash:

Cash budgets can be prepared for any time period:

- Near term forecast are usually prepared in months.
- Useful because they take account of seasonal variations in cash flows.
- Where cash flow is volatile, shorter periods might be more appropriate e.g. weekly.
- If cash flows are relatively stable longer periods may suffice e.g. quarterly.

Topic 3: Working Capital Management:

Working Capital Cycle:

(4) Cash:

In general, the further into the future that cash is being forecast, the more uncertain the forecast.

Also, the cash budget is only as useful as the accuracy of the other forecasts upon which it relies e.g. Sales forecasts.

Where there is significant uncertainty surrounding a business’s cash flows, a business should provide for a cash cushion or ensure ready access to short term borrowing.

Topic 3: Working Capital Management:

Working Capital Cycle:

(4) Cash:

Cash budgets are subject to the accuracy of the forecast inputs, and chief amongst these is the sales forecast.

Sales forecast can be based on an internal analysis or external analysis.

With an internal approach, sales executives are asked to project sales for the period being forecast.

These estimates are reviewed by sales managers and consolidated into an overall estimate for the firm.

While this has the advantage of ‘Close to the Ground’ prediction, it can be short-sighted, sometimes biased, and industry and economic trends may be overlooked.

Topic 3: Working Capital Management:

Working Capital Cycle:

(4) Cash:

This can be tempered somewhat by an external analysis.

An external analysis takes account of economic trends and looks at developments in the industry.

By combining both internal and external analyses a more comprehensive view of the environment is taken leading to more accurate assessments of future cash flows.

Topic 3: Working Capital Management:

Working Capital Cycle:

(4) Cash:

Once the sales forecast is prepared, the next step is to determine the cash receipts from these sales.

There are a number of factors take into account in this regard:

- What value of sales (if any) are paid for in cash.
- What value of sales are subject to credit terms.
- What percentage of credit customers pay to terms.
- What percentage of customers exceed terms, and by what extent are term exceeded.

Topic 3: Working Capital Management:

Working Capital Cycle:

(4) Cash:

Gregory Ltd is to form a company in July 2022 to sell Stationery Products:

Shareholders invest €80,000 of which €50,000 to be used for Furniture & Fittings. These to be depreciated over 4 years.

Forecasted Sales and cost data as follows:
(All numbers following are in 000s of euros)

	Jul-22	Aug-22	Sep-22	Oct-22	Nov-22	Dec-22	Total
Sales	30.0	30.0	37.5	52.5	73.5	102.9	326.4
Purchases	28.0	26.0	25.0	29.0	30.0	26.0	164.0
Wages	4.0	5.0	5.0	6.0	6.0	6.0	32.0

- Sales levels anticipated at €30,000 per month for July and August
- A Direct Marketing Campaign invested in during September cost €40,000. This was paid in full during September.
- Sales levels increase by 40% each month from September to December as a result of the Marketing Campaign
- Sales issued on credit and paid after two months
- One month credit given by suppliers
- Rent and rates is €15,000 per quarter payable in advance on 1st. day of the quarter.
- All other costs paid in cash

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Working Capital Cycle:

CASH FLOW	Jul-22	Aug-22	Sep-22	Oct-22	Nov-22	Dec-22
	€000	€000	€000	€000	€000	€000
Cash Inflows						
Share Issue	80.0	0.0	0.0	0.0	0.0	0.0
Debtors / Sales	0.0	0.0	30.0	30.0	37.5	52.5
Total Cash Inflow	80.0	0.0	30.0	30.0	37.5	52.5
Cash Outflows						
Furniture & Fittings	50.0	0.0	0.0	0.0	0.0	0.0
Purchases	0.0	28.0	26.0	25.0	29.0	30.0
Rent & Rates	15.0	0.0	0.0	15.0	0.0	0.0
Marketing	0.0	0.0	40.0	0.0	0.0	0.0
Wages	4.0	5.0	5.0	6.0	6.0	6.0
Total Cash Outflow	69.0	33.0	71.0	46.0	35.0	36.0
Opening Balance	0.0	11.0	-22.0	-63.0	-79.0	-76.5
Closing Balance	**11.0**	**-22.0**	**-63.0**	**-79.0**	**-76.5**	**-60.0**

Topic 3: Working Capital Management:

Managing Working Capital:

(1) Managing Debtors / Receivables:

Trade receivables are a significant proportion of the business's balance sheet.

It is also unreliable because:

- Credit policies are often vague or not properly implemented.
- Management of debt may not receive the attention it deserves.
- Poor policies and management can lead to bad debts.

Topic 3: Working Capital Management:

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Managing Working Capital:

(1) Managing Debtors / Receivables:

Management of receivables involves finding the right balance between:

- Extending credit to increase sales (profitability) and;
- The cost of employing finance administration staff and the risk of bad debts.

Managing credit given to customers requires balancing profitability and liquidity.

Topic 3: Working Capital Management:

Managing Working Capital:

(1) Managing Debtors / Receivables:

Before extending credit, an organisation needs to evaluate the risk of default or non-payment :

- Trade references from other suppliers.
- Bank references.
- Credit agency reports.
- Published information (for example annual financial statements).
- Trial period for cash only sales.
- Setting credit limits low initially and increased if payment record warrants it.

Topic 3: Working Capital Management:

Managing Working Capital:

(2) Managing Inventory:

There are other costs associated with inventory other than the goods themselves. These can generally be categorised as either ordering costs or holding costs. Ordering costs related to costs incurred each time an order is placed.

Examples:

- Administration
- Authorisation
- Receiving goods
- Checking goods

Topic 3: Working Capital Management:

Managing Working Capital:

(2) Managing Inventory:

In addition, inventory come at a high cost of holding the product.

Examples:

- Cost of financing
- Storage
- Handling
- Insurance
- Administration
- Obsolescence
- Deterioration
- Theft

Topic 3: Working Capital Management:

Managing Working Capital:

(2) Managing Inventory:

The lower the levels of inventory, the more likely an increase in profitability

Reducing inventory is in the control of management (in contrast to reducing receivables or increasing payables which rely on third party cooperation)

As much as is practical, the aim is for fast and frequent replenishment of inventory while at the same time minimised holding cost

Topic 3: Working Capital Management:

Managing Working Capital:

(2) Managing Inventory:

A method of assisting in minimising the overall inventory costs is the Economic Order Quantity (EOQ).

The EOQ model looks to minimise costs by balancing holding costs and ordering costs.

Large batches ordered result in high holding costs and low ordering costs.

The opposite also applies - if small batches are ordered this will result in low holding costs and high ordering costs.

Topic 3: Working Capital Management:

Managing Working Capital:

(2) Managing Inventory:

The EOQ looks to optimise the position between holding and ordering costs:

Economic Order Quamtity

$$EOQ = \sqrt{\frac{2\,cd}{h}}$$

Where: c = Cost per Order
d = Annual demand for item of inventory
h = Holding cost of a unit

Topic 3: Working Capital Management:

Managing Working Capital:

(2) Managing Inventory:

Example:
A company has an annual demand for 2,000 units. The cost of placing an order is €20 and the annual cost of holding an item of inventory is €2. Calculate the economic order quantity:

Economic Order Quamtity

$$EOQ = \sqrt{\frac{2\,cd}{h}}$$

Where:
- c = Cost per Order
- d = Annual demand for item of inventory
- h = Holding cost of a unit

$$EOQ = \sqrt{\frac{(2 \times 20 \times 2{,}000)}{2}}$$

$$EOQ = \sqrt{40{,}000}$$

EOQ = 200 units

Topic 3: Working Capital Management:

Managing Working Capital:

(3) Managing Creditors / Payables:

Trade credit is a form of short-term financing for firms.

It is a cheap form of finance but not without implications.

Some of the costs associated with this form of financing are:

- Loss of supplier goodwill - Can be difficult to quantify, but if the credit period is regularly overdone suppliers may refuse orders or expect cash payment in advance.
- Higher unit costs - Where a customer takes excessive credit, the supplier might try to recover the cost through charging higher prices.
- Loss of cash discount if the full credit period is used - Where full credit is taken discounts may be foregone.

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Managing Working Capital:

(3) Managing Creditors / Payables:

Despite the drawbacks, trade credit is the largest source of short-term funds for most businesses.

The main advantages of trade credit are:

- Obtaining credit is generally informal.
- It is a flexible source of finance.
- It is relatively stable as a source of finance and continuously available.
- No security is required (unlike other forms of credit).

Topic 3: Working Capital Management:

Managing Working Capital:

(4) Cash Management:

Organisations should look to hold the minimum amount of cash for its needs.

The main motives for holding cash funds are:

- Transaction motive- To meet day to day commitments.
- Precautionary motive - To provide for unforeseen events.
- Speculative motive - To take advantage of unexpected opportunities.

Where a firm has access to short term funds, the amount of cash it needs to hold can be reduced.

Topic 3: Working Capital Management:

Managing Working Capital:

(4) Cash Management:

If the business holds assets that can be easily converted to determine then the amount of cash can also be reduced.

The exact amount of cash a business should hold is hard to determine: different businesses have different requirements.

A bank overdraft is probably one of the most important short term financing options particularly for businesses involved in seasonal trade.

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Managing Working Capital:

(4) Cash Management:

Term loans are another form of finance available for a fixed term

Repayments are in equal instalments over the term of the loan.

Early repayment of term loans often incurs an early settlement penalty.

The main advantages of term loans are:

- The term can be arranged to suit the borrowers needs.
- The repayment profile can be negotiated to suit expected cash flows.
- The interest rate is fixed so the company is not exposed to increases in interest rates.

Topic 3: Working Capital Management:

Managing Working Capital:

(4) Cash Management:

The cash budget plays a role in both planning and control.

Cash surpluses or cash deficits can be identified to allow managers take appropriate action in an appropriate time frame.

Cash budgets are a very important a tool in managing the liquidity of a firm.

Where a firm is likely to have a surplus of short-term funds it is important to make use of them.

Topic 3: Working Capital Management:

Managing Working Capital:

(4) Cash Management:

Possible uses of short-term funds :

- Short term deposits.
- Certificates of deposit (CDs) are flexible because they aren't negotiable.
- Short term Treasury Bills - a fixed return that is known if held to maturity.
- Reduction in overdraft which will reduces interest costs.

Topic 3: Working Capital Management:

End of Section Questions 1:

(a) Why is it important to monitor the cash balance on a daily basis?

(b) What corrective action should be taken to ensure there is enough cash available to pay key stakeholders at times of quiet trading conditions?

(c) What options are available to management when a business has or anticipates a surplus of cash?

Topic 3: Working Capital Management:

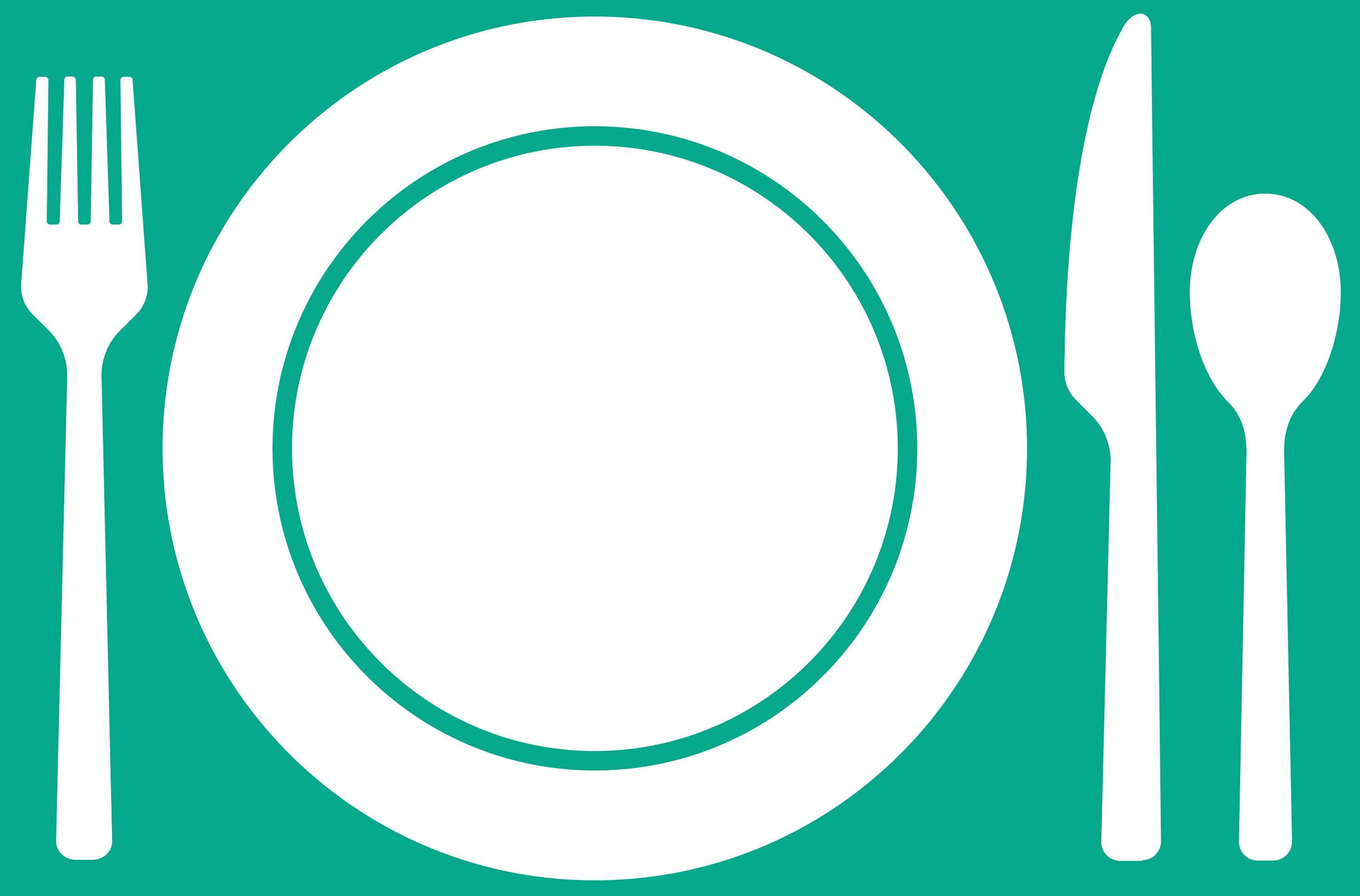
End of Section Questions 2:

(a) How can management ensure the credit terms offered to customers are applied without affecting the relationship with them?

(b) How can management ensure the credit terms received from suppliers are applied without affecting the relationship with them?

(c) What factors must be considered when deciding on how much or little inventory should be held?

Lunch



Topic 4: Management Accounts

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Introduction:

Accounting is the process of:

- Identifying,
- Measuring and
- Communicating financial information about an entity

To permit :

- Informed judgements and
- Decisions by users of the information.

Management Accounting is Identifying, measuring and communicating for:

- …..informed judgements and decisions by internal users of the information.

Topic 4: Management Accounts

Introduction:

Management Functions:

- Planning
- Decision Making
- Control

Topic 4: Management Accounts

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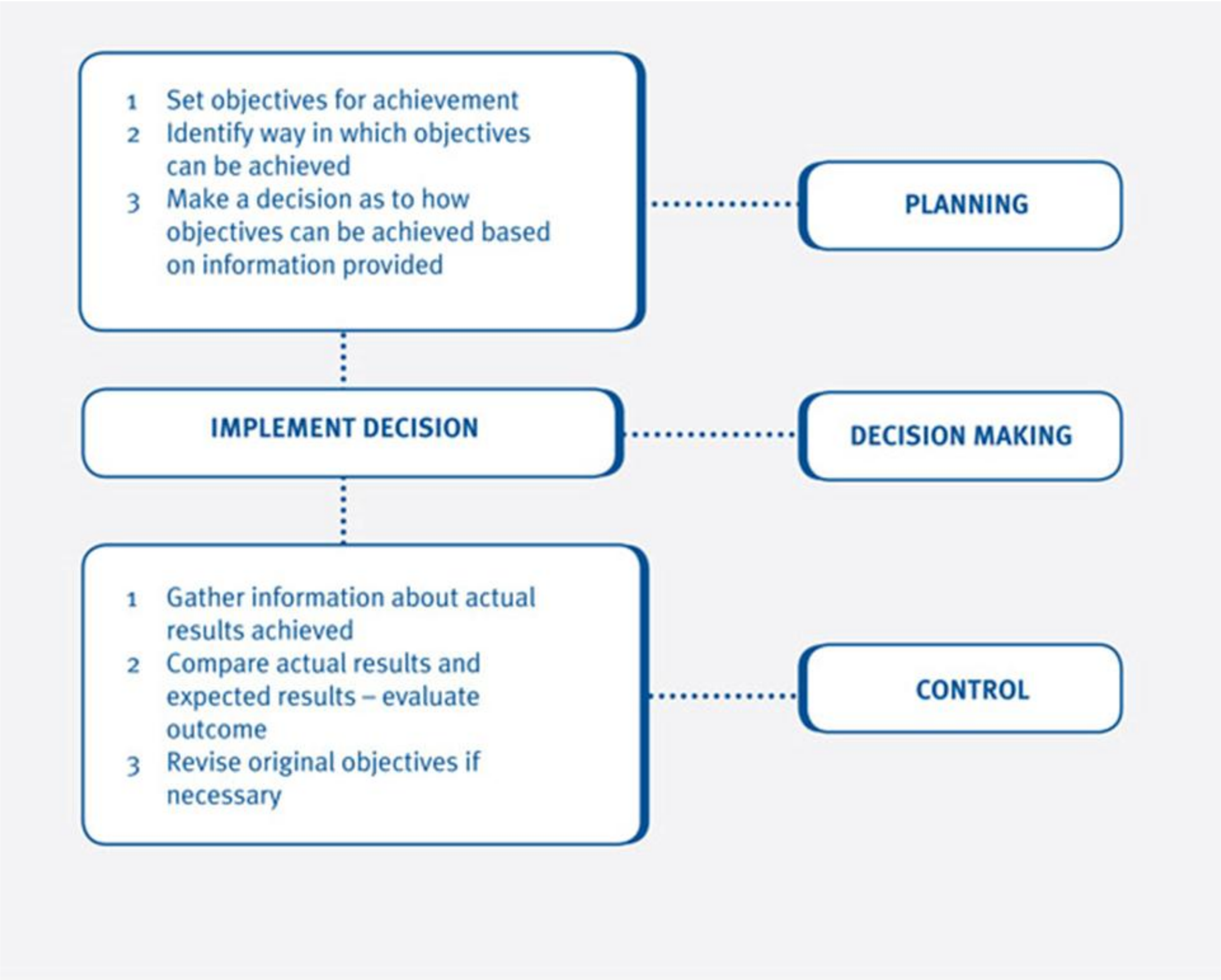

Topic 4: Management Accounts

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Management Control System:

- A management control system is a system which measures and corrects the performance of activities of subordinates in order to make sure that the objectives of an organisation are being met and the plans devised to attain them are being carried out.

Topic 4: Management Accounts

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- The focus of management reports is to enhance the decision-making capabilities of managers.
- The indicators that provide the key information in this respect will have their own reports or will be central to general management reporting
- Depending on the department and the manager in question, the report will differ.

Topic 4: Management Accounts

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- Key Performance Indicators (KPIs) are the quantifiable measurements used to gauge a business's long-term performance.
- They help determine the strategic, financial, and operational achievements of an organisation.
- The focus of management reports is to enhance the decision-making capabilities of managers.
- The indicators that provide the key information in this respect will have their own reports or will be central to general management reporting
- Depending on the department and the manager in question, the KPI will differ.

Topic 4: Management Accounts

Typical KPIs:

- Revenue growth
- Revenue per client
- Profit margin
- Client retention rate
- Customer satisfaction

Topic 4: Management Accounts

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Characteristics of a Good KPI:

- Provides clear, objective information of progress towards a target.
- Tracks and measures factors such as efficiency, quality, timeliness, and performance.
- Provides a way to measure performance over time.
- Ultimately, helps management make informed decision.

Topic 4: Management Accounts

Provide examples of what management information reports would be produced for the managers of the following departments / functions:

- Marketing
- IT
- HR
- Operations
- Finance

Topic 4: Management Accounts

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(1) Marketing:

- Sales Reports (by customer, product, location etc.)
- Headcount and Payroll Report
- Agency Spend Report
- Campaign Return on Investment
- Customer Satisfaction Report
- Customer Retention Report

Topic 4: Management Accounts

(2) IT:

- Software Licences Expenditure Report
- Computer Hardware Expenditure Report
- Fixed Asset Register
- Headcount and Payroll Report
- Network Reliability Report

Topic 4: Management Accounts

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(3) HR:

- Staff Recruitment Expenditure Report
- Staff Training Expenditure Report
- Employee Satisfaction Report
- Headcount and Payroll Report (department and overall)
- Performance Evaluation and Incentives Report

Topic 4: Management Accounts

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(4) Operations:

- Sales Reports (by customer, product, location etc.)
- Inventory Turnover Report
- Materials Procurement Report
- Headcount and Payroll Report
- Sales Returns Report (by customer, product, location etc.)

Topic 4: Management Accounts

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(5) Finance:

- Sales Reports (by customer, product, location etc.)
- Expenditure Reports
- Credit Control (Debtor Days) Reports
- Payables (Creditor Days) Reports
- Headcount and Payroll Report
- Weekly / Monthly / Quarterly Management Accounts

Coffee Break

Topic 5: Preparing a Business Plan to secure long-term cash investment:

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Business planning is a way of managing time, and of anticipating the future.

Business forecasting is an integral part of this planning process

Forecasting is an attempt to illustrate how a market or another external environmental variables will behave during the planning period based on assumptions.

It is important to define and describe the processes of planning and forecasting: the role of forecasting within the business planning process must be analysed.

Topic 5: Preparing a Business Plan to secure long-term cash investment:

The essential feature of Capital Investment Decisions is Time

Investment means the outlay of something of economic value (usually cash) at one point in time which is expected to yield economic benefit at some other point in time.

The outlay is usually large whereas the benefits are a series small benefits over a period of time

Topic 5: Preparing a Business Plan to secure long-term cash investment:

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Capital Investment Decisions tend to be of profound importance to the business for the following reasons:

- Large amounts of Resources Required
- Often difficult and / or expensive to pull out of the Investment once committed to it.

Topic 5: Preparing a Business Plan to secure long-term cash investment:

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Examples of long-term decisions involving Capital Investing resources include:

- Building a new production facility
- Buying a new delivery truck
- Building a bridge
- Making a new product
- Starting a new business

Topic 5: Preparing a Business Plan to secure long-term cash investment:

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Decisions concerning long-term future investments are often made on the basis of :

- The sum to be invested in a capital project
- The estimated returns from the projects
- The length of time the project is expected to last
- The economic conditions prevailing at the time eg. Interest rates

Topic 5: Preparing a Business Plan to secure long-term cash investment:

Decisions concerning long-term future investments are often made on the basis of :

- Accounting techniques in assessing project profitability
- Make calculations using these techniques
- Sources of funds for financing projects
- Capital expenditure is spending on non-current assets
- Expect future benefits but over the long term
- Impact on working capital
- Improvement versus maintenance
- Matching of costs and benefits

Topic 5: Preparing a Business Plan to secure long-term cash investment:

Some costs are not relevant to the capital spend decision

Examples of these are:

- Costs that will be incurred anyway
- Sunk costs (money already spent)
- Committed costs

Topic 5: Preparing a Business Plan to secure long-term cash investment:

Capital Investment – Steps:

1) Identify available funds
2) Identify profitable projects
3) Define and classify projects
4) Evaluate projects
5) Approve selection and authorise
6) Monitor

Topic 5: Preparing a Business Plan to secure long-term cash investment:

Methods of Capital Investment Appraisal:

- Payback method
- Accounting rate of return method
- Net present value (Discounted Cashflows)
- Internal rate of return

Topic 5: Preparing a Business Plan to secure long-term cash investment:

(1) Payback Method:

- Considers the number of years to recover initial investment from the cashflows of the project
- The time the investment takes to pay for itself
- Expressed in years/months
- Accept shortest payback
- Set a target payback e.g. 3 years
- Very common amongst managers, but not technically the best method
- Often used as a “screening device”

Topic 5: Preparing a Business Plan to secure long-term cash investment:

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(1) Payback Method:

$$\text{Payback period} = \frac{\text{Initial payment}}{\text{Annual cash flow}}$$

If cash flows are uneven then payback is calculated using the cumulative cash flow over the life of the investment.

Topic 5: Preparing a Business Plan to secure long-term cash investment:

(1) Payback Method:

Payback Example 1:

A Vehicle costs 10,000 with an expected annual cash flow of 2,500, what is the payback period?

$$\text{Payback Period} = \frac{\text{Initial Payment (10,000)}}{\text{Annual Cash Flow (2,500)}}$$

Payback period = 4 years

Topic 5: Preparing a Business Plan to secure long-term cash investment:

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(1) Payback Method:

Payback-time to recover investment.

Payback Rules:

- Firm sets benchmark. e.g Must payback in 2 years
- Accept if payback period is less than benchmark
- Reject if payback period is greater than benchmark
- In competing projects fastest payback gets selected

Topic 5: Preparing a Business Plan to secure long-term cash investment:

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(2) Accounting rate of return (ARR) Method:

- Measures the profitability of an investment by calculating the expected average profits as a % of the cost of the original investment.
- If the Project % exceeds target it will show financial justification
- The ARR of a project is estimated and if it exceeds a target, the project should be accepted.
- Also sometimes known as Return on Capital Employed (ROCE) or Return on Investment (ROI).

Topic 5: Preparing a Business Plan to secure long-term cash investment:

(2) Accounting rate of return (ARR) Method:

$$\text{ROCE} = \frac{\text{Average annual profit before interest and tax}}{\text{Initial capital costs}} \times 100\%$$

Strengths

- Expressed in terms familiar to managers – profit and capital employed.
- Easy to calculate the likely effect of the project on the reported profit and loss account/balance sheet. Managers are frequently rewarded in relation to performance against these variables.
- Business is judged by ROI by financial markets.

Limitations

- Does not ensure that shareholder wealth is maximised
- Figures easily manipulated
- Ignores the actual/incremental cash flows associated with the project

Topic 5: Preparing a Business Plan to secure long-term cash investment:

(2) Accounting rate of return (ARR) Method:

Example :

Company X has a target ARR of 20%

Proposal:
€80,000 Estimated cost of asset
Life : 4 years

Estimated profit after depreciation:

	€
Year 1	5,000
Year 2	10,000
Year 3	7,000
Year 4	3,000

Topic 5: Preparing a Business Plan to secure long-term cash investment:

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(2) Accounting rate of return (ARR) Method:

Example :

Total profit after depreciation:		25,000
Average profit:	25,000 / 4 years=	6,250
Average Investment	80,000 / 2 =	40,000

ARR $\frac{6,250}{40,000}$ X 100= 15.6%

Company target is 20%, therefore reject the project

Topic 5: Preparing a Business Plan to secure long-term cash investment:

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(3) Net present value (Discounted Cashflow)

When analysing the method of Capital Investment it is important to consider:

a) All Cash Flows for each investment opportunity

b) Make logical allowance for the TIMING of those Cash Flows

The next method of investment appraisal is Net Present Value which looks at the Timing of cash flows

Topic 5: Preparing a Business Plan to secure long-term cash investment:

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(3) Net present value (Discounted Cashflow)

- Need appraisal method that takes into account all cash flows of project and timing of same
- Net Present Value or NPV
- Sum of PVs of cash flows both positive and negative
- Widely used in capital budgeting and project appraisal.
- How do you get it? Discount all cash flows to PV.
- Rate reflects risk and time value of money.

Topic 5: Preparing a Business Plan to secure long-term cash investment:

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(3) Net present value (Discounted Cashflow)

- Risk…you might not get return when time comes
- Time value of money…interest and inflation
- Interest you would have earned if you did not invest
- Inflation means buying power of your money is less in the future
- Investor needs to be compensated for risk and time value.
- Higher the risk, higher the required return
- Rate is based on what alternative investment of similar risk would yield.
- Discount rate =opportunity cost of finance = cost of capital

Topic 5: Preparing a Business Plan to secure long-term cash investment:

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(3) Net present value (Discounted Cashflow)

NPV rules:

- Accept where NPV is greater than zero. (i.e positive)
- Reject where NPV is less than zero i.e negative
- If competing projects accept highest
- Formula: $$\mathrm{PV} = \frac{C}{(1+r)^t}$$

Topic 5: Preparing a Business Plan to secure long-term cash investment:

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(3) Net present value (Discounted Cashflow)

- For this method we need to estimate future cashflows
- There maybe uncertainty about these cashflows
- The interest rate chosen will be based on either the internal rate of return or an external rate of return
- Allows us to compare projects
- Project with highest NPV is chosen

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(3) Net present value (Discounted Cashflow)

Add all the discounted cashflows and if the result is:

- Positive NPV, this means % return is greater than target cost of capital = ACCEPT
- Negative NPV, means return is less than target cost of capital= REJECT
- Zero means return is equal to cost of capital

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(3) Net present value (Discounted Cashflow)

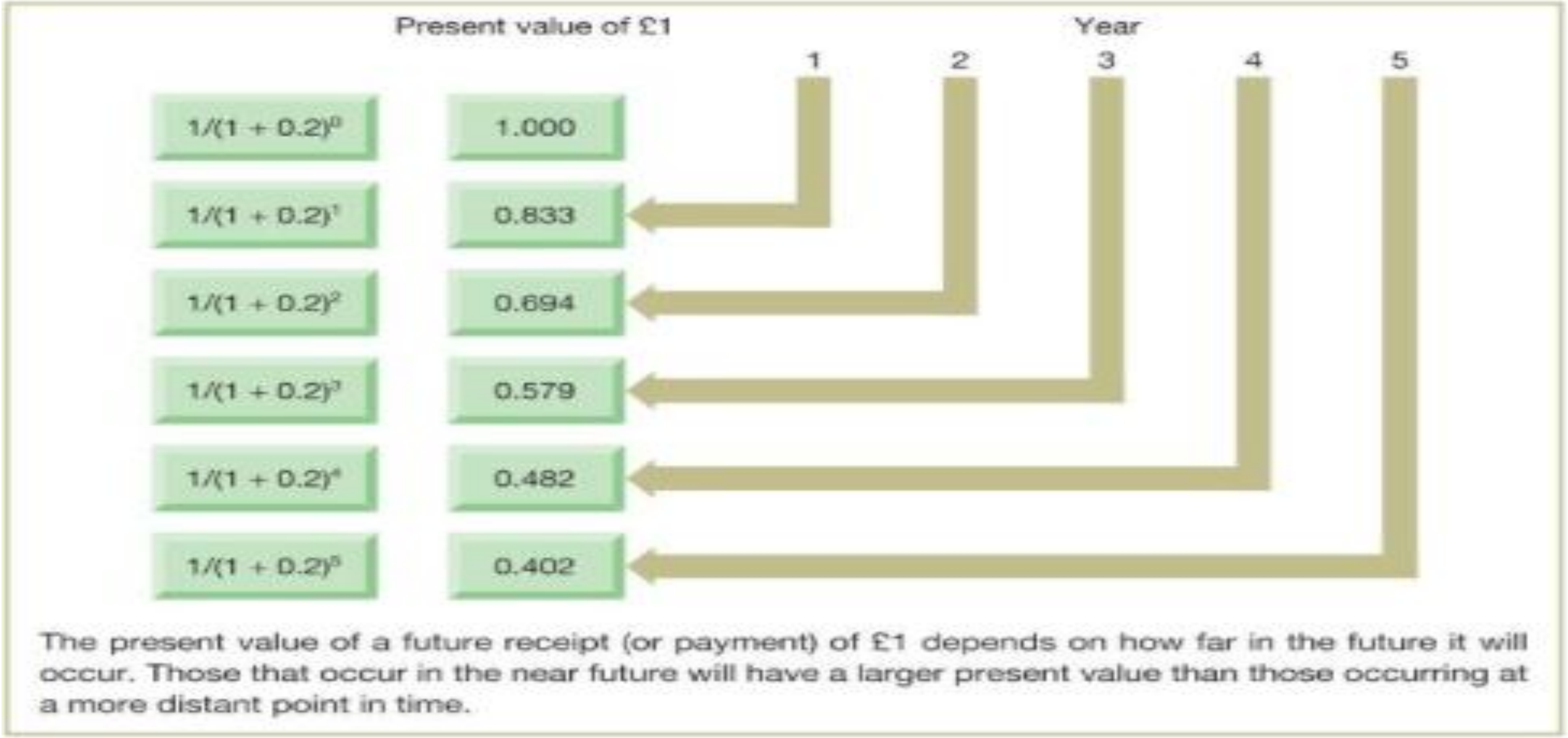

Figure 4.4 Present value of £1 receivable at various times in the future, assuming an annual financing cost of 20 per cent

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(3) Net present value (Discounted Cashflow)

Example :

A machine will cost €120,000 to finance
It has an expected life of 4 years with a residual value of €15,000

The yearly expected cash inflows are as follows:

Y1 30,000
Y2 45,000
Y3 60,000
Y4 15,000

Cost of capital is 10% p.a.

Calculate the NPV using the formula

Topic 5: Preparing a Business Plan to secure long-term cash investment:

(3) Net present value (Discounted Cashflow)

Example :

		DF @ 10%	P.V. (divide by 1+r)
Y0	(120,000)	1.0	(120,000)
Y1	30,000	1.1	27,270
Y2	45,000	1.12	37,170
Y3	60,000	1.13	45,060
Y4	30,000	1.14	20,490
		N.P.V.	9,990

Positive result , therefore accept.

Topic 5: Preparing a Business Plan to secure long-term cash investment:

(3) Net present value (Discounted Cashflow)

Investment decisions are determined by cash flows but which cash flows? The following are essential to understand in plotting cash flows for investment decisions:

- Use Incremental cash flows;
  relevant to and arising directly from taking on a project . Difference between with and without
- Do not use Sunk Costs;
  costs which have already been incurred and cannot be removed. E.G Architects fees. Not relevant to analysis
- Use Opportunity Costs;
  revenues foregone as a result of making the proposed investment. Most valuable alternative that is given up.
  Incorporate opportunity costs into analysis

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(4) Internal Rate of Return (IRR):

Refer to the rate that makes the estimated NPV of an investment equal to zero. Can calculate it through trial and error until you find it.

IRR rule:

- Accept project if IRR bigger than required rate.
- Closely related to NPV and leads to exactly same decisions for conventional independent projects.
- Why ? Because if IRR gives zero NPV, anything smaller will give positive NPV since you are discounting (dividing by) a smaller number.

Topic 5: Preparing a Business Plan to secure long-term cash investment:

Capital Structure:

- The capital structure of an organisation is made up of long-term borrowing (debt) and shareholders funds (equity)
- This is the way an organisation finances its operations in the first place and subsequently how investments are made in significant projects and capital expenditure.
- It is important to understand the distinction between debt and equity.
- It is also key to identify the sources of capital both debt and equity, short and long term.

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Capital Structure:

- Sources of Long-Term Finance:

- Borrowings
- Finance leases, including sale- and leaseback arrangements
- Hire purchase
- Ordinary shares
- Preference shares

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Capital Structure:

(1) Borrowing:

- Contract with lender specifying interest rate, dates of repayments of interest and capital and security for loan.
- Risk of default.
- Fixed charge may be on specific assets.
- Floating charge overall to become fixed on specific when certain events happen.
- Security usually on most saleable non-current assets e.g property.

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Capital Structure:

(a) Term Loan:

- A term loan is a loan of a fixed amount for an agreed time and on specified terms
- Normally three to seven years.
- Repayment term varies.
- Terms to be agreed including draw down and interest on same.
- The interest charged on term loans can be at either fixed or floating rates.

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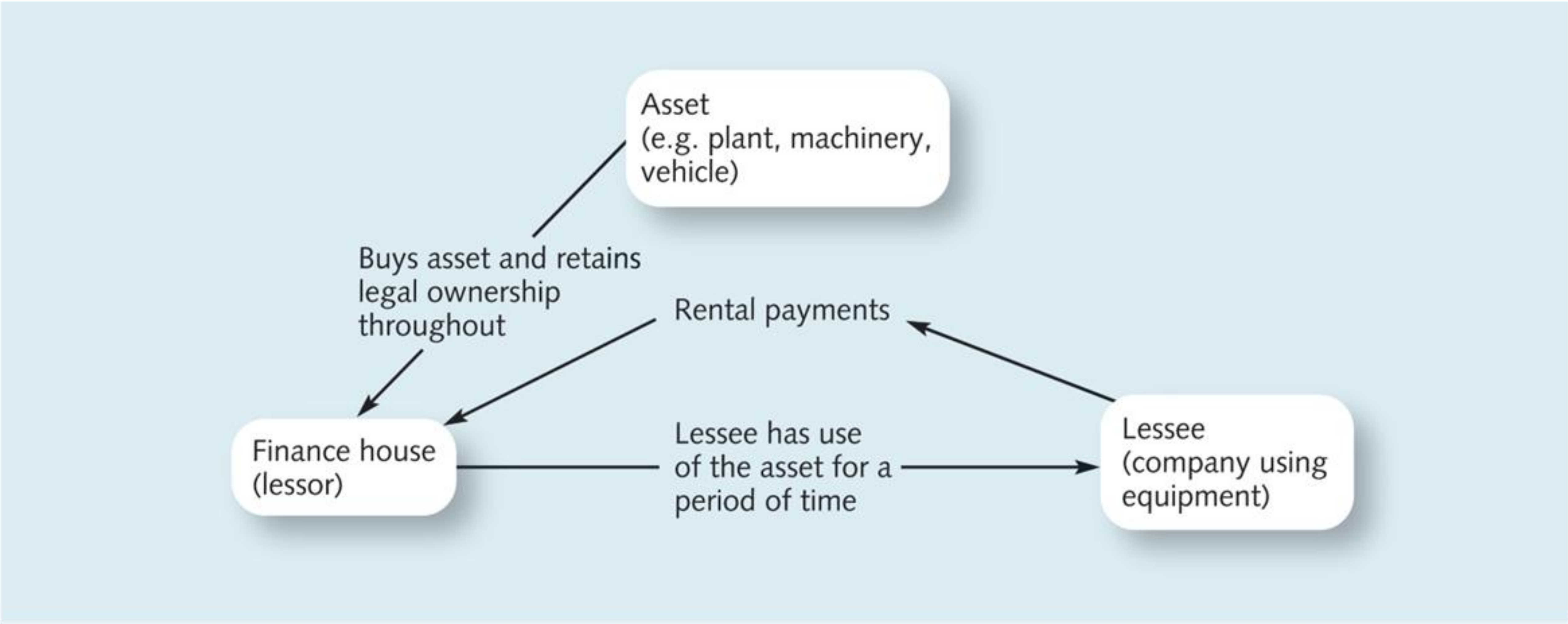
Capital Structure:

(c) Leasing:



Topic 5: Preparing a Business Plan to secure long-term cash investment:

Capital Structure:

(c) Leasing:

(1) Finance lease:
- The finance provider expects to recover the full cost (or almost the full cost) of the equipment, plus interest, over the period of the lease
- Often no right of cancellation or termination
- The lessee bear the risks and rewards that normally go with ownership
- The lessee is responsible for maintenance, insurance, repairs and obsolescence

(2) Operating lease:
- Relatively short-term contract
- Not expected to last for the entire useful life of the asset
- Finance house bears the risk of ownership

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Capital Structure:

(d) Hire Purchase:

- Vendor credit, buyer buys goods on credit.
- Pays vendor in instalments after initial deposit.
- Buyer acquires ownership of the asset after a certain number of payments.

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Capital Structure:

(f) Ordinary Share Capital:

- Ordinary share capital is the capital that is received or given by the owners of a business in exchange for shares.
- Ordinary shares usually rank after preference shares (see below) for the purpose of dividends and returns of capital but carry voting rights not normally attributed to preference shareholders.
- Ordinary shareholders are entitled to the residue after other parties are rewarded.
- This applies to both annual profits and capital on a winding up.

Topic 5: Preparing a Business Plan to secure long-term cash investment:

Capital Structure:

(g) Preference Share Capital:

- Lower risk than ordinary shareholder.
- Fixed dividend if profit.
- Priority.
- No voting rights.
- Redeemable.
- Dividend not tax deductible, interest is.
- Similar to loan as far as business is concerned but less attractive for tax issue.

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Capital Structure:

Share Capital: Advantages to the Company

- No fixed annual charges are payable. No legal obligation to pay a dividends.
- Do not have a maturity date and are not redeemable (normally).
- Usually more attractive to investors than fixed interest securities.
- Might increase the creditworthiness of the company, as they reduce "gearing".

Topic 5: Preparing a Business Plan to secure long-term cash investment:

Capital Structure:

Share Capital : Disadvantages to the Company

- Issue might reduce Earnings Per Share (EPS), especially if funds acquired do not produce immediate results.
- Extend voting rights to more shareholders.
- Lower gearing might result in a higher cost of capital.
- Substantial issue and underwriting costs.
- Dividends are not tax allowable.

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Capital Structure:

(h) Retained Earnings:

- Finance not distributed to ordinary shareholders.
- Reinvested in business.
- Works in early years and at times of crisis.
- May result in a capital appreciation.
- May be viewed negatively if shareholders want to make a short term return.

Topic 5: Preparing a Business Plan to secure long-term cash investment:

End of Section Questions 1:

(a) What options are available to a large publicly quoted company in generating finance long term finance?

(b) What options are available to a small / medium sized company in generating long term finance?

(c) Why is it important to match the cash flows of an investment with the repayments of debt?

Topic 5: Preparing a Business Plan to secure long-term cash investment:

End of Section Questions 2:

(a) What is the cost of equity capital to a company?

(b) What are the advantages in issuing ordinary shares to generate finance

(c) What are the disadvantages in issuing ordinary shares to generate finance?

Thank you

Questions??