The Fundamental Finance Function

Have you ever thought about starting your own business? If so, you've probably considered the goods or services you'll sell, where you'll open your store, and how you'll market your product. You may think you've considered everything, but you probably haven't thought about capital investment decisions or working capital management. While these terms might not be the first things to come to your mind, no business can exist successfully (or exist for very long at *all*) without a healthy finance function and smart financial managers.

Finance is the area of a business that relates to all money management matters. It contributes to the business as a whole and is interrelated with all the other business functions. Read on to learn more about the importance of finance, its role in business, and some of the specific decisions that financial managers must make to keep their companies going strong.

What do you think of when you hear the word "finance"? You might think of a verb or a noun. You might think of money. You might even think of finance as a major in college! No matter what you think of when you hear "finance," the word is very important in the business world. In business, **finance** is the function that involves all money and money management matters. It also encompasses all the tools and analyses that financial managers use to make decisions involved in that money management. A company's financial managers have a few main goals, including ensuring that the business is as profitable as it can be and reducing the business's financial risks.

▲ Financial managers have an important job…they're in charge of making sure that the business is as profitable as it can be and reducing the business's financial risks. Finance encompasses all the tools and analyses that financial managers can use to make decisions about money management.

Objectives

A. Describe the role of finance in a business organization.

B. Discuss capital investment decisions and working capital management.

Risk management within the finance function refers to using financial instruments to manage exposure to risk. Two main types of financial risk are credit risk and market risk. Credit risk is the risk of financial loss due to non-payment from a debtor or customer (anyone who owes the company money). Market risk is the risk of financial loss due to the decreased value of an investment.

Finance vs. accounting

Do you know the difference between finance and accounting? If not, don't feel bad—they're closely interrelated and even overlap in some areas. Telling the difference can become even more confusing in small businesses where a few employees (or even just one!) are responsible for the whole company's finance and accounting activities. However, there are several key differences between the finance and accounting functions.

First, they are distinct in focus. The finance function primarily focuses on money management *decisions*, while accounting focuses on recordkeeping *activities*. **Accounting**, remember, is the process of keeping and interpreting financial records.

The two functions are also different in their ultimate purposes. The purpose of the finance function is to boost the company's growth and to reduce its risks. The purpose of the accounting function is to provide accurate and timely information about the company's finances at any point in time.

It's easy to see how these two functions work together. The accounting function records and generates the information needed to plan and make decisions in the finance function. This is not to say that accountants never make decisions or that financial managers never keep records. There is just a difference in *primary* focus and purpose.

Finance activities

Financial managers have many responsibilities, which may vary from company to company, but there are a few *main* finance activities. The first is the administration of assets, or decisions about investments. Every company has **assets**—things it owns that are of value. Financial managers are responsible for determining what types of assets the company should own, as well as the proper mix of those assets. They make these decisions based on what they think will be best for the company's overall value.

Acquisition of funds, or decisions about financing, is the other main responsibility of a company's finance department. Although financing and finance might *sound* similar, they're very different! **Financing** is the process of funding a business venture. It is one of the *activities* that financial managers undertake within the finance function. When a company wants to spend money to develop a new product or purchase new equipment, it must obtain financing to pay for it. There are many different ways a business can obtain financing, and there are advantages and disadvantages to each method. Financial managers must decide which method or methods will be most beneficial for the company.

▲ What do cash, buildings, and vehicles have in common? They're all assets that a company can own. Cash is a current asset, while buildings and vehicles are capital assets.

It's clear that financial managers put a lot of time and effort into the administration of assets and the acquisition of funds. These decisions involve quite a bit of planning, analysis, forecasting, and budgeting. Together, these efforts make up the primary finance activities of a business.

There are several different types of assets that a company can own. Current assets are assets with continually changing value, such as cash or inventory. Capital assets refer to property the company permanently owns. This can include land, equipment, buildings, vehicles, etc. Investments are considered assets as well.

The importance of finance

Finance serves many important purposes within a business, including:

- *Helping to set goals for the future.* Successful companies are always thinking about and planning for the future, whether it involves a new product line, a merger or acquisition, or a new business facility. The finance function helps companies accomplish their goals by producing budgets and strategies for moving forward. It also ensures that the business's financial priorities are in line with its organizational priorities and objectives.

- *Planning and controlling the company's spending.* Companies have to spend money to make money, but that doesn't mean they should spend *all* of their money! A system must be in place to plan and control that spending so that it stays within the company's budget and still allows the company to make a profit. That's where the finance function comes in. It provides a central "hub" for monitoring company spending throughout all the different departments.

▲ Finance serves many important purposes within a business. For example, what if a company wants to build a new business facility? The finance function can help it achieve that goal by producing budgets and strategies for moving forward.

- *Ensuring sufficient financing.* As you know, acquisition of funds is a main finance activity. A business relies on its finance function to make sure that adequate funds will be available, not only for financing new projects or equipment, but also for paying debts and taxes. Financial managers must keep close track of a business's **accounts payable**, or all the money the business owes.

- *Making sure customers pay their bills.* If customers don't pay their bills on time (or at all!), it's hard for a company to make money! That's where accounts receivable comes in. The flip side of accounts payable, accounts receivable are all the money owed to the business by others. The finance function keeps an eye on accounts receivable to make sure the business receives the money it is owed. It's important for financial managers to balance accounts payable and receivable and ensure that the company's cash flow stays positive.

- *Investing company money wisely.* This refers to the administration of assets. It is absolutely essential for a company's financial managers to make smart investment decisions. They can make or break a company financially.

In short, the finance function contributes to the company by keeping it on track in terms of money. Obviously, this is vital to the success of any business!

How finance fits in

Every part of a company is tied to finance in some way or another. You already know how closely finance and accounting are related. But money is involved in *every* aspect of a business. Think about what's involved in producing and marketing a product—it takes money to buy the raw materials, to convert them into the finished product, to purchase advertising, and so much more. The money needed to spend on these activities is controlled by the finance department.

◄ Finance is involved in every aspect of a business. The money needed to buy raw materials, convert them into finished products, and purchase advertisements is controlled by the finance department.

Finance has a close relationship with information systems as well. Good communication between the finance department and all other departments in a business is essential. Information systems (any instruments of communication within a business) keep the flow of information and communication between all departments going. Without honest financial communication, a company would probably have to deal with lots of confusion and mistakes.

A company's finance department is usually involved in, if not responsible for, the budgeting process. This affects all other business activities. It also affects individual employees because the budgeting process provides for salaries, benefits, etc.

Finally, the finance function helps top management plan for new business projects and strategies. Let's say a packaged-food company is interested in developing a new cake mix. It will involve some research, some testing, and some new equipment. The financial managers will review the proposal with management and help them determine whether or not the plan is financially feasible. Or, let's say a large banking institution is interested in merging with or acquiring a smaller bank. The finance function works with management to determine which mergers or acquisitions would add value to the business.

Summary

Finance is the business function that involves all money and money management matters. The finance and accounting functions are closely related but distinct in several ways. The main finance activities are the administration of assets and the acquisition of funds. Finance serves many important purposes within a business, including helping to set goals for the future and planning and controlling the company's spending. Every part of the company is tied to finance in some way or another.

A

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1. What is finance?
2. What are the differences between finance and accounting?
3. What are two main finance activities?
4. How does the finance function contribute to the business?
5. How does finance relate to other business activities?

The Gray Zone

Chris is a financial manager for a small business. Right now, he's working on next year's budget. Money is tight, and each department has requested more money than Chris is able to budget for it. His best friend works in marketing and is pressuring Chris for an extra $5,000 for her advertising budget. Chris doesn't want to disappoint her, but granting her the favor would mean taking money away from other departments. The decision is up to him, and his boss will trust his judgment. What should Chris do? Is it all right to let a personal relationship influence his budgeting decisions?

B

Comprehending Capital

Capital investment decisions vs. working capital management

Now that you understand the finance function, it's time to get down to the nitty gritty of some of the most important decisions that financial managers face. First, we need to learn the difference between capital investment decisions and working capital management. **Capital investment decisions** determine which projects the business will invest in, how the investment(s) will be financed, and whether or not to pay dividends to the company's shareholders. **Working capital management** focuses on the company's current balance of assets and liabilities. It involves the management of accounts payable and receivable, inventory, and cash.

Sound confusing? The trick to remembering the difference between capital investment decisions and working capital management is to think of them in terms of time. Capital investment decisions are made for the long-term. They involve company projects that will (in theory) last for years into the future. If a manufacturing company is considering purchasing a second facility, this would be considered a capital investment decision. Working capital management involves decisions made for the short-term. In most cases, working capital management refers to accounts payable and receivable that will be settled within one year.

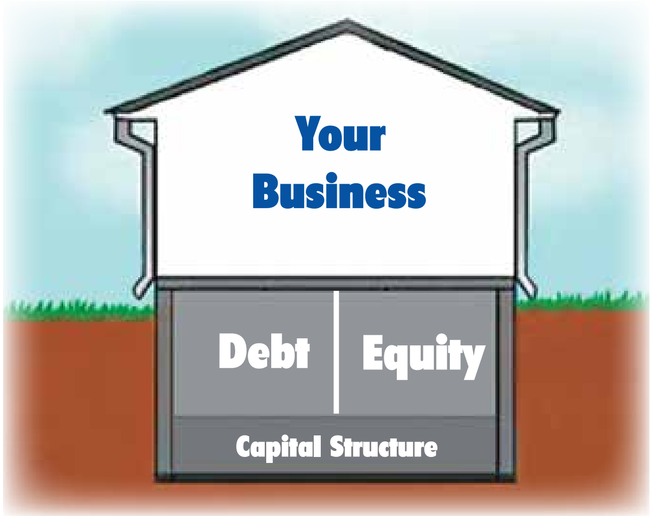
Working capital is the difference between current assets and current liabilities. Sometimes referred to as operating capital, it can be expressed as either a positive or negative number.

Capital investment decisions

Let's break down the decisions involved in capital investment management. First, a company's financial managers determine which projects it should invest in. This process is known as **capital budgeting**. The managers make these decisions through the involved process of estimating each potential project's value to the business. In other words, financial managers ask themselves "How likely is it that the new project will be profitable?"

Second, the managers determine how to finance the new project(s). They must figure out the "optimal mix" of financing, or **capital structure**. Usually, a company's capital structure consists of some combination of debt and equity. **Debt** refers to taking out a loan from a bank or other lending institution. **Equity** refers to assets the company already owns. For example, the packaged-food company determines that a new mocha cake mix is the best project to invest in. While the company will probably take out a loan to finance part of the new project, it already has some equity. The employees and machinery that the company already has are considered equity if they can contribute towards the new project as well. In this way, the company can finance the project from within. Equity can also mean cash. If a company happens to have a few million dollars available, it might use it for purchasing new equipment or even acquiring a smaller company.

The goal of most businesses is to make a profit. When a business does, one of its capital investment decisions is to determine whether or not to pay **dividends** to its shareholders and, if so, when and how much. If the company chooses to pay dividends, it must decide whether to pay them in the form of cash or in the form of stock. If the company does not choose to pay dividends, it will use its profits to either finance new projects or reinvest in existing ones. It's up to the financial managers to decide what's best for the company.

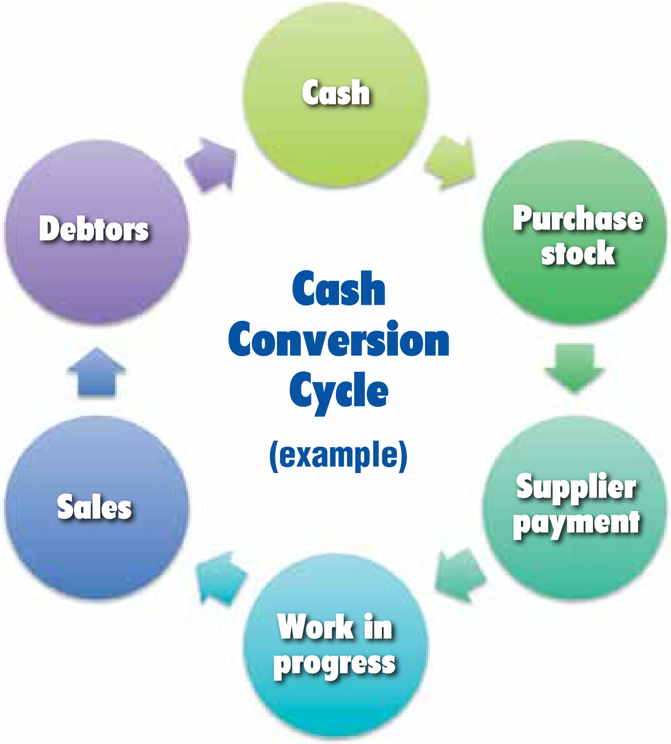


▲ How are new projects financed? By using an "optimal mix" of financing, or capital structure. A company's capital structure is usually a mix of debt and equity.

Working capital management and cash conversion cycles

A key component of managing working capital is the **cash conversion cycle**. The cash conversion cycle goes by many names, including asset conversion cycle, working capital cycle, net operating cycle, or even just cash cycle. It is a ratio that refers to the number of days between a company's paying for raw materials and receiving cash from selling the products made from those raw materials. Financial managers want to keep the cash conversion cycle as short as possible because a longer conversion cycle means that the company's money is tied up longer. Of course, financial managers want to have as much free cash to work with as possible!

When investors consider investing in a company, they often look at the cash conversion cycle as an indicator of whether or not the company has good working capital management. A downward trend in the cycle is a positive sign, while an upward trend is a negative one.



(Net Profit – Taxes) ÷ Total Capital = Return on Capital
Return on capital is determined by dividing net profit (minus taxes) by total capital.

Return on capital

Return on capital (also known as return on invested capital) is another key component of managing working capital. It is a measure of how well a business generates cash flow in relation to the capital (both debt and equity) it has already invested in itself, and it is usually expressed as a percentage. When return on capital is positive, the company is growing in value; when it is negative, the company is losing value.

Financial managers need to make sure that return on capital remains high. Remember, they're responsible for helping the company to grow in value. If the packaged-food company has invested $10 million in itself through both debt (loans) and equity (financing from within), and its net profit is $1 million, its return on capital is positive—10 percent—and the company is growing in value. This is a reasonable growth expectation. If the net profit is negative, however, the company is losing value.

▲ Financial managers want the return on capital to be positive—this means that the company is growing in value.

Summary

Capital investment decisions determine which projects the business will invest in, how the investment(s) will be financed, and whether or not to pay dividends to the company's shareholders. Working capital management focuses on the company's current balance of assets and liabilities. Two main components of working capital management are the cash conversion cycle and return on capital. The cash conversion cycle is a ratio that refers to the number of days between a company's paying for raw materials and receiving cash from selling the products made from those raw materials. Return on capital is a measure of how well a business generates cash flow in relation to the capital it has already invested in itself.

1. What is the difference between capital investment decisions and working capital management?
2. What are three capital investment decisions?
3. What is a cash conversion cycle?
4. What is return on capital?

Make It Pay!

Think about the finance department at the business where you work. What is it like? How many managers work in it? Are finance and accounting combined? Consider the things that you think your finance department does well. Are there any things you would do differently?

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