# Financial Management: Important Generalizations[1]

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## Introduction

The objectives of this article on financial management are twofold: (1) to provide an overview of the importance of professional financial management to a business firm's operations and (2) to discuss nine financial management viewpoints that tend to restrict the financial performance of business organizations.

Historically, there has been a common belief in the business community that because of the numerous complexities and uncertainties involved, financial management should be the responsibility of a specialist—the money manager. Today, a more appropriate view is that, because all business decisions impact financial performance, every manager must be a money manager. Furthermore, it is even being suggested by many that all organizational employees need a basic understanding of financial performance if optimum levels of overall business performance are to be realized.

## General Observations

Strategic financial management is one of the most critical and important activities for the professional business manager. It is a fact that the consequences of all important management decisions are reflected in the financial performance of the business enterprise. Unfortunately, some managers and business owners have relatively little professional exposure to, and training in, strategic financial management. Unless minimum financial performance levels are achieved, it is impossible for a business enterprise to survive over time. Firms that are started with limited financial reserves will have a shorter life if they are unable to operate at minimum cost. So, what is the minimum cost of staying in business? According to management expert Peter Drucker (1980), a firm's minimum cost of staying in business is equivalent to its current cost of capital. That is, if a firm's return on net worth is not at least equivalent to the rate at which it can borrow money from creditors, it is not achieving its cost of staying in business. Therefore many firms showing a bottom-line profit but low return on net worth are not earning their minimum cost of staying in business even though they are somewhat profitable.

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1. document is FRE343, one of a series of the Food and Resource Economics Department, UF/IFAS Extension. Original publication date June 2002. Revised July 2019. Visit the EDIS website at https://edis.ifas.ufl.edu for the currently supported version of this publication.

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## Inappropriate Financial Management Perspectives

Basic generalizations regarding the financial management viewpoints of many US business owners and managers can be identified. Some practices and viewpoints tend to restrict business firm profitability. They interfere with management practices that can improve firm financial performance. Therefore owners and managers need to evaluate the extent to which the following nine financial viewpoints apply to their management team.

### Profits Are Residuals

Most managers view profits as *residuals*. That is, profits are viewed as being what is left over after total business expenses are subtracted from total revenue. The problem with viewing profits as a residual is that the size of the residual may be insufficient for long-term business growth and survival. Does your management team tend to view profits as a residual?

### Profits Are Not a Legitimate Business Expense

Profits are *not* generally viewed as a legitimate business *expense*. Managers sometimes do not recognize that profits are return-to-owner capital, just as interest is return-to-creditor capital. Return-to-owner capital might earn a higher return in other investments. Does your organization view profits as a legitimate business expense?

### Current Cost of Staying in Business Equals Current Cost of Capital

Managers often do not recognize that the Current Cost of Staying in Business (CCSB) is equivalent to the firm's Current Cost of Capital (CCC). Therefore a positive bottom line (a positive net profit) does not necessarily mean that the firm has been truly profitable. Does your management team know your organization's Current Cost of Staying in Business and whether or not your firm is earning profits at a level high enough to permit it to stay in business in the future?

### Positive Net Profit Does Not Equal Profitability

When a firm does not achieve its Current Cost of Staying in Business (CCSB), its Current Cost of Capital (CCC), management does not realize that, in reality, it has operated at a loss. This exists even though the firm may have a positive bottom line. Low, positive bottom-line profits will not ensure future firm survival. Does your management team automatically associate a positive net profit with financial success?

### Financial Success Is Not Synonymous with Sales Size and Profits

Financial success is viewed as being synonymous with the size of the sales and net profit entries reflected in the firm's Operating Statement (also called a profit and loss, or P&L, statement). In reality, an increase in sales and/or net profits does not automatically mean the firm has been more profitable. It is possible for both of these to increase and for the organization to have experienced a decrease in overall financial performance. An example would involve the situation where the capital utilized increased at a faster rate than sales and profits. Does your management team view financial success as being primarily revealed by Operating Statement entries?

### The Importance of Balance Sheet Accounts

Managers sometimes do not recognize the impact and importance of Balance Sheet accounts (assets, liabilities, and net worth) in determining business profitability. Profitability is defined as dollar net profits divided by dollar net worth. Therefore Balance Sheet accounts are at least as important as Operating Statement accounts when determining the financial success of an organization. Does your management team consider the Balance Sheet Statement in profitability determination?

### Managing for Profitability Versus Managing for Profits

Managers sometimes do not recognize the difference between managing for profitability as contrasted to managing for profits. They often do not realize that profitability can *decrease* during periods when profits are *increasing*. Profits are the bottom line of the Operating (P&L) Statement. Profitability is dollar net profit divided by dollar net worth. It requires both the Operating Statement and the Balance Sheet to determine it. Yet, most managers are profit rather than profitability focused. Does your management team manage for profits or for profitability?

### Net Profit Margin Is Only One Important Financial Measure

Managers generally perceive net profit margin as the most important financial performance measure in determining business firm profitability. In reality, there are five financial

measurement factors that determine profitability: % net profit margins, asset turnover, return on assets, equity multiplier, and return on equity

| (%) Profit Margin x Total Asset Turnover = Return on Assets x Equity Multiplier = Return on Equity |
|---|

Figure 1. DuPont analysis

Business profitability, measured as a return to the owner's equity, can be determined by multiplying % Net Profit Margin times Asset Turnover times Equity Multiplier (Keown et al. 2001). In this equation, which generates the same answer as dividing dollar net profit by dollar net worth, all five financial measures are of *equal* importance in determining profitability. A 10% change in any one of these measures will result in a 10% change in the profitability ratio. Does your management team recognize the basic determinants of business profitability, and how each is calculated?

### Effective Management of Financial Performance Goals

The management team should establish financial performance goals, including profitability goals. The management team that does these activities can readily answer the following four financial management questions:

1. The management team should establish financial performance goals, including profitability goals. The management team that does these activities can readily answer the following four financial management questions: How profitable was your firm last year? ___________%

2. What constituted the minimum adequate level of profitability for your firm? (i.e., what is your firm's current cost of staying in business?) _____________%

3. What is your firm's profitability goal for the current operating period? ___________%

4. What is your firm's five-year profitability goal? ________%

## Concluding Remarks

In a competitive marketplace, many business firms struggle to earn a satisfactory level of profitability. Yet, without appropriate profitability rates, firms will not survive over time. One only has to witness the number of firms (small and large alike) that have filed for bankruptcy protection and closed their doors to realize that business ownership does not automatically assure financial success.

There is no question that many business owners and managers need to improve their financial management professionalism. This article identified nine financial management viewpoints that, when they exist, tend to restrict financial performance. By recognizing the fallacies associated with these viewpoints, owners and managers have the opportunity to apply more professional financial management practices to their organization. The result may well be a more financially healthy firm.

## References

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