FINANCIAL MANAGEMENT UPPER TOOLS

1.1 STUDIES OF THE FINANCIAL STATEMENTS:

Financial analysis is part of management accounting.
Management accounting in a type of accounting that uses managers to study financial information of a company. They analyze the information and their primary purpose is to provide ideas internally to enhance the company's profitability strategies. All the information they analyze is given to them from financial accountants.

- Management accountants do not prepare any of the daily financial work of a company. They are simply given the information and their job is to analyze and investigate the information they are given. The information they use for analyzing is company financial statements and other types of reports.

Financial Statements

- Financial statements are the primary source of information used by management accountants. These accountants use the financial statements as most of their investigation. They compare the financial statements to prior periods and look for patterns and changes. They also study the budget to actual numbers and look for variances. All variances are investigated by management accountants as part of their financial analysis.

Ratios

- Management accountants analyze financial information in many ways. One tool they use often is financial ratios. Two common ratios are the current ratio and the quick ratio. A current ratio divides current assets by current liabilities. A quick ratio takes current assets minus inventories and then divides it by current liabilities. Both of these ratios determine if a company's liquidity and cash flow are in good shape or not. Ratios are calculated often and compared to historical figures of the company and of the industry.

Budgets

- After analyzing financial information, management accountants summarize their findings from the information. These findings are summarized in the form of reports. The reports are then passed along to upper management where decisions are made. One use of the information management accountants find is determining budgets. Upper-level management creates a budget based on this information.

Strategic Planning

- Strategic planning is another use of financial analysis by management accountants. Upper-level management determines strategic plans for the future of the company. This includes things such as new product development and strategies for increasing sales.

1.2 FINANCIAL ADMINISTRATOR JOB: What Financial Managers Do?

Financial managers perform data analysis and advise senior managers on profit-maximizing ideas.

Financial managers are responsible for the financial health of an organization. They produce financial reports, direct investment activities, and develop strategies and plans for the long-term financial goals of their organization.

Duties

Financial managers typically do the following:

- Prepare financial statements, business activity reports, and forecasts
- Monitor financial details to ensure that legal requirements are met
- Supervise employees who do financial reporting and budgeting
- Review company financial reports and seek ways to reduce costs
- Analyze market trends to find opportunities for expansion or for acquiring other companies
- Help management make financial decisions

The role of the financial manager, particularly in business, is changing in response to technological advances that have substantially reduced the amount of time it takes to produce financial reports. Financial managers' main responsibility used to be monitoring a company's finances, but they now do more data analysis and advise senior managers on ideas as to how to maximize profits. They often work on teams, acting as business advisors to top executives.

Financial managers also do tasks that are specific to their organization or industry. For example, government financial managers must be experts on government appropriations and budgeting processes, and healthcare financial managers must know about issues in healthcare finance. Moreover, financial managers must be aware of special tax laws and regulations that affect their industry. For more information on chief financial officers, see the profile on top executives.

The following are examples of types of financial managers:

Controllers direct the preparation of financial reports that summarize and forecast the organization's financial position, such as income statements, balance sheets, and analyses of future earnings or expenses. Controllers also are in charge of preparing special reports required by governmental agencies that regulate businesses. Often, controllers oversee the accounting, audit, and budget departments of their organization.

Treasurers and ***finance officers*** direct their organization's budgets to meet its financial goals. They oversee the investment of funds and carry out strategies to raise capital (such as issuing stocks or bonds) to support the firm's expansion. They also develop financial plans for mergers (two companies joining together) and acquisitions (one company buying another).

Credit managers oversee their firm's credit business. They set credit-rating criteria, determine credit ceilings, and monitor the collections of past-due accounts.

Cash managers monitor and control the flow of cash that comes in and goes out of the company to meet the company's business and investment needs. For example, they must project cash flow (amounts coming in and going out) to determine whether the company will not have enough cash and will need a loan or will have more cash than needed and so can invest some of its money.

Risk managers control financial risk by using hedging and other strategies to limit or offset the probability of a financial loss or a company's exposure to financial uncertainty. Among the risks they try to limit are those due to currency or commodity price changes.

Insurance managers decide how best to limit a company's losses by obtaining insurance against risks such as the need to make disability payments for an employee who gets hurt on the job and costs imposed by a lawsuit against the company

1.3 MANAGE FUNDS - FINANCIAL RISK: Managing Investment Risk

When you invest, you take certain risks. With insured bank investments, such as certificates of deposit (CDs), you face inflation risk, which means that you may not earn enough over time to keep pace with the increasing cost of living. With investments that aren't insured, such as stocks, bonds, and mutual funds, you face the risk that you might lose money, which can happen if the price falls and you sell for less than you paid to buy.

Just because you take investment risks doesn't mean you can't exert some control over what happens to the money you invest. In fact, the opposite is true.

If you know the types of risks you might face, make choices about those you are willing to take, and understand how to build and balance your portfolio to offset potential problems, you are managing investment risk to your advantage.

Why Take Risks?

The question you might have at this point is, "Why would I want to risk losing some or all of my money?" In fact, you might not want to put money at risk that you expect to need in the short term—to make the down payment on a home, for example, or pay a tuition bill for next semester, or cover emergency expenses. By taking certain risks with the rest of your money, however, you may earn dividends or interest. In addition, the value of the assets you purchase may increase over the long term.

If you prefer to avoid risk and put your money in an FDIC-insured certificate of deposit (CD) at your bank, the most you can earn is the interest that the bank is paying. This may be good enough in some years, say, when interest rates are high or when other investments are falling. But on average, and over the long haul, stocks and bonds tend to grow more rapidly, which would make it easier or even possible to reach your savings goals. That's because avoiding investment risk entirely provides no protection against inflation, which decreases the value of your savings over time.

On the other hand, if you concentrate on only the riskiest investments, it's entirely possible, even likely, that you will lose money.

For many people, it's best to manage risk by building a diversified portfolio that holds several different types of investments. This approach provides the reasonable expectation that at least some of the investments will increase in value over a period of time. So even if the return on other investments is disappointing, your overall results may be positive.

Types of Investment Risk

There are many different types of investment risk. The two general types of risk are:

- Losing money, which you can identify as investment risk
- Losing buying power, which is inflation risk

It probably comes as no surprise that there are several different ways you might lose money on an investment. To manage these risks, you need to know what they are.

Most investment risk is described as either systematic or nonsystematic. While those terms seem intimidating, what they refer to is actually straightforward.

Systematic Risk

Systematic risk is also known as market risk and relates to factors that affect the overall economy or securities markets. Systematic risk affects all companies, regardless of the company's financial condition, management, or capital structure, and, depending on the investment, can involve international as well as domestic factors. Here are some of the most common systematic risks:

- **Interest-rate risk** describes the risk that the value of a security will go down because of changes in interest rates. For example, when interest rates overall increase, bond issuers must offer higher coupon rates on new bonds in order to attract investors. The consequence is that the prices of existing bonds drop because investors prefer the newer bonds paying the higher rate. On the other hand, there's also interest-rate risk when rates fall because maturing bonds or bonds that are paid off before maturity must be reinvested at a lower yield.

- **Inflation risk** describes the risk that increases in the prices of goods and services, and therefore the cost of living, reduce your purchasing power. Let's say a can of soda increases from $1 to $2. In the past, $2 would have bought two cans of soda, but now $2 can buy only one can, resulting in a decline in the value of your money.

  Inflation risk and interest rate risk are closely tied, as interest rates generally rise with inflation. Because of this, inflation risk can also reduce the value of your investments. For example, to keep pace with inflation and compensate for the loss of purchasing power, lenders will demand increased interest rates. This can lead to existing bonds losing value because, as mentioned above, newly issued bonds will offer higher interest rates. Inflation can go in cycles, however. When interest rates are low, new bonds will likely offer lower interest rates.

- **Currency risk** occurs because many world currencies float against each other. If money needs to be converted to a different currency to make an investment, any change in the exchange rate between that currency and yours can increase or reduce your investment return. You are usually only impacted by currency risk if you invest in international securities or funds that invest in international securities.

  For example, assume that the current exchange rate of the U.S. dollar to British pound is $1=0.53 British pounds. If you invest $1,000 in a mutual fund that invests in the stock of British companies, this will equal 530 pounds ($1,000 x 0.53 pounds = 530 pounds). Six months later, assume the dollar strengthens and the exchange rate becomes $1=0.65 pounds. If the value of the fund does not change, converting the original investment of 530 pounds into dollars will return only $815 (530 pounds/0.65 pounds = $815). Consequently, while the value of the mutual fund has not changed in the local currency, a change in the exchange rate has devalued the original investment of $1,000 into $815. On the other hand, if the dollar were to weaken, the value of the investment would go up. So if the exchange rate changes to $1=0.43 pounds, the original investment of $1,000 would increase to $1,233 (530 pounds/0.43 pounds = $1,233).

As with most risks, currency risk can be managed to a certain extent by allocating only a limited portion of your portfolio to international investments and diversifying this portion across various countries and regions.

- **Liquidity risk** is the risk that you might not be able to buy or sell investments quickly for a price that is close to the true underlying value of the asset. Sometimes you may not be able to sell the investment at all if there are no buyers for it. Liquidity risk is usually higher in over-the-counter markets and small-capitalization stocks. Foreign investments can pose liquidity risks as well. The size of foreign markets, the number of companies listed, and hours of trading may limit your ability to buy or sell a foreign investment.

- **Sociopolitical risk** is the possibility that instability or unrest in one or more regions of the world will affect investment markets. Terrorist attacks, war, and pandemics are just examples of events, whether actual or anticipated, that impact investor attitudes toward the market in general and result in system-wide fluctuations in stock prices. Some events, such as the September 11, 2001, attacks on the World Trade Center and the Pentagon, can lead to wide-scale disruptions of financial markets, further exposing investments to risks. Similarly, if you are investing overseas, problems there may undermine those markets, or a new government in a particular country may restrict investment by non-citizens or nationalize businesses.

Your chief defense against systematic risk, as you'll see, is to build a portfolio that includes investments that react differently to the same economic factors. It's a strategy known as asset allocation. This generally involves investing in both bonds and stocks or the funds that own them, always holding some of each. That's because historical patterns show that when bonds as a group—though not every bond—are providing a strong return, stocks on the whole tend to provide a disappointing return. The reverse is also true.

Bonds tend to provide strong returns, measured by the combination of change in value and investment earnings, when investor demand for them increases. That demand may be driven by concerns about volatility risk in the stock market— what's sometimes described as a flight to safety— or by the potential for higher yield that results when interest rates increase, or by both factors occurring at the same time.

That is, when investors believe they can benefit from good returns with less risk than they would be exposed to by owning stock, they are willing to pay more than par value to own bonds. In fact, they may sell stock to invest in bonds. The sale of stock combined with limited new buying drives stock prices down, reducing return.

In a different phase of the cycle, those same investors might sell off bonds to buy stock, with just the opposite effect on stock and bond prices. If you owned both bonds and stocks in both periods, you would benefit from the strong returns on the asset class that was in greater demand at any one time. You would also be ready when investor sentiment changes and the other asset class provides stronger returns. To manage systematic risk, you can allocate your total investment portfolio so that it includes some stock and some bonds as well as some cash investments.

Nonsystematic Risk

Nonsystematic risk, in contrast to systematic risk, affects a much smaller number of companies or investments and is associated with investing in a particular product, company, or industry sector.

Here are some examples of nonsystematic risk:

- **Management risk**, also known as company risk, refers to the impact that bad management decisions, other internal missteps, or even external situations can have on a company's performance and, as a consequence, on the value of investments in that company. Even if you research a company carefully before investing and it appears to have solid management, there is probably no way to know that a competitor is about to bring a superior product to market. Nor is it easy to anticipate a financial or personal scandal that undermines a company's image, its stock price, or the rating of its bonds.

- **Credit risk**, also called default risk, is the possibility that a bond issuer won't pay interest as scheduled or repay the principal at maturity. Credit risk may also be a problem with insurance companies that sell annuity contracts, where your ability to collect the interest and income you expect is dependent on the claims-paying ability of the issuer.

One way to manage nonsystematic risk is to spread your investment dollars around, diversifying your portfolio holdings within each major asset class—stock, bonds, and cash—either by owning individual securities or mutual funds that invest in those securities. While you're likely to feel the impact of a company that crashes and burns, it should be much less traumatic if that company's stock is just one among several you own.

Other Investment Risks

The investment decisions you make—and sometimes those you avoid making—can expose you to certain risks that can impede your progress toward meeting your investment goals.

For example, buying and selling investments in your accounts too frequently, perhaps in an attempt to take advantage of short-term gains or avoid short-term losses, can increase your trading costs. The money you spend on trading reduces the balance in your account or eats into the amount you have to invest. If you decide to invest in something that's receiving a lot of media attention, you may be increasing the possibility that you're buying at the market peak, setting yourself up for future losses. Or, if you sell in a sudden market downturn, it can mean not only locking in your losses but also missing out on future gains.

You can also increase your investment risk if you don't monitor the performance of your portfolio and make appropriate changes. For example, you should be aware of investments that have failed to live up to your expectations, and shed them when you determine that they are unlikely to improve, using the money from that sale for another investment.

Assessing Risk

It's one thing to know that there are risks in investing. But how do you figure out ahead of time what those risks might be, which ones you are willing to take, and which ones may never be worth taking? There are three basic steps to assessing risk:

- Understanding the risk posed by certain categories of investments
- Determining the kind of risk you are comfortable taking

- Evaluating specific investments

You can follow this path on your own or with the help of one or more investment professionals, including stockbrokers, registered investment advisers, and financial planners with expertise in these areas.