

Importance of financial information in determining Business Strategy

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EXECUTIVE SUMMARY

The report has been prepared with the primary objective of analysing the importance of financial information in preparing the business strategies. An analysis of financial statements has been conducted to analyse their importance and relevance to business strategies. The requirements of long term and short term finance have been discussed along with their sources. The ownership structures of businesses have been included in the report along with corporate governance structure and requirements.

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Table of Contents

Task 1.....	5
1.1 Need for financial information for a business	5
1.2 Business Risk Impacting Financial Decisions	6
1.3 Importance of Financial Information in Strategic Decision Making	7
Task 2.....	8
2.1 Purpose, Structure and Content of Published Accounts	8
2.1.1 Income Statement.....	8
2.1.2 Statement of Financial Position	9
2.1.3 Statement of Changes in Equity.....	9
2.1.4 Statement of Cash Flows	9
2.2 Calculation and Interpretation of Financial Ratios	10
2.2.1 Current Ratio.....	10
2.2.2 Debt to Equity Ratio	10
2.2.3 Net Profit Margin.....	11
2.2.4 Debt to Assets Ratio.....	11
Task 3.....	12
3.1 Long and Short Term Financing for an Organization.....	12
3.2 Sources of Short Term and Long Term Finance.....	13
3.2.1 Short Term Finance.....	13
3.2.2 Long Term Finance	14
3.3 Cash Flow Management.....	14
3.3.1 Use of Technology.....	14

3.3.2 Optimisation of Financial Functions.....	14
3.3.3 Matching of Funds to Obligations of Cash Flows	15
3.4 Investment Appraisal Methods	15
Task 4.....	17
4.1 Ownership Structure and Corporate Governance	17
Roles and Responsibilities of Stakeholders	17
References	19
Appendix 1.....	21

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Importance of financial information in determining Business

Strategy

Task 1

1.1 Need for Financial Information for a Business

Financial information is a key aspect in determining the successful decision making process. The financial information is extracted from financial statements and accounting information systems in order to enhance the process of decision making (Zager and Zager, 2006). According to Jarvis et al (2000), financial information is a critical factor that leads to business success of any type and size. Financial information can be examined and analysed in order to measure and determine the quality of a business. Financial information can be useful for a business in order to interpret the financial transactions and the cash flow it has been generating.

Similarly, financial information is vital for companies to interpret their business operations. Small businesses have relatively limited financial information available to them. Financial information can be reviewed by the owners of the company in order to determine the performance of their operations (Higgins and Reimers, 1995). On the other hand, financial information can be used to extract the insight of a business growth and opportunities for expanding the existing business operations.

Financial information can be extracted using the financial statements of a business that includes income statements, cash flows and balance sheets. Apart from assessing the performance of the operations, it can be used to compare the performance of a business with its competitors. Moreover, financial information can be vital for the owners to allocate a budget to the operations of a business and can be further used to make business decisions such as

diversifying the investment, purchase of material and resources, estimating the sales for future and analysing the aspects of expanding and other opportunities (Healy and Palepu, 2012).

1.2 Business Risk Impacting Financial Decisions

Business risks are the risks that a business can encounter and that can bring negative influence on the operations and financial decisions of a business. Business risks can be defined as risks that relates to viability of a business (Koller, 2005). It refers to the ability of a company to increase sufficient sales and revenue in order to cover its operational costs and generate a profit. The business risk is influenced by certain factors which include profit margins, demand of the products, cost of goods sold and the competition in the industry.

Business risks can be either defined as systematic or unsystematic risks (Beja, 1972). Systematic risks are the risks that the companies cannot restrict or control such as fluctuating economy or political/market instability. On the other hand, unsystematic risks are the risks that a company engages in and can be countered using the management skills and abilities.

On the other hand, market risk is one the risks that a business encounters when making a financial decision. The following risks contain the understanding of fluctuating exchange rate, interest rates and market liquidity. Secondly, before making a financial decision, it is vital for companies to take into account the risk of laws and regulation and focus upon any changes that government proposes. Furthermore, environmental risk and risk of corruption/terrorism can impact the financial decision that a company makes.

Some of the other business risks also include investment risks, production risks and consumer related risks that could have an impact on financial decisions.

1.3 Importance of Financial Information in Strategic Decision Making

In order to conduct an effective decision making, it is vital for companies to interpret financial information through the analyses of financial statement. It can be stated that the analyses of financial statement is a process of converting financial statements into important information that could be utilized for the measuring the quality of business operations through adoption of various analytical tools that have an essential part in the process of decision making and rational management (Blessing, n.d). Therefore, it is a significant approach to analyse the current business quality in order to make business decision and ensure the development of a company and its existence in the market.

It has been studied that financial information is a vital component in business planning which leads to an effective decision making. In order to make strategic decisions, companies need to analyse the strengths and weaknesses of the businesses. It is important for a company to recognize the strengths to take the most of the advantage while weaknesses could be used to make corrective decisions. This could lead to an effective management of a business as companies are analysing the financial information before implementing any specific decision.

Companies can extract critical information through the analyses of financial information that could provide an understanding of business finance including liquidity. Financial information can be used to determine the impact of certain strategic decision for example financial information can be used to diversify the investments (Nawaz, 2011). Furthermore, the financial information can be used to generate financial ratios that could be used to interpret the

current position of a business and the concerning factors that need to be solved in order to perform effectively and profitably.

Task 2

2.1 Purpose, Content and Structure of Published Accounts

The financial statements prepared by a company have four components which are:

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

2.1.1 Income Statement

The income statement of a company depicts the profit or loss incurred by a firm in a particular time interval. It shows the operations of a company and is also known as profit and loss account. The structure of income statement shows revenue of the company and expenses incurred (Wild et al., 2004). The cost of goods sold in the period is deducted from revenue in order to arrive at the gross profit and then operational expenses are deducted to come to the figure of net profit/loss of the company in that particular period. A sample of income statement is shown in Appendix 1.

2.1.2 Statement of Financial Position

The balance sheet or the statement of financial position has the potential to tell the financial strength of the company and its ability to distribute dividends to the owner of company. The statement is prepared for a specific period of time. The statement of financial position reflects shareholders' equity, assets, and liabilities (Stickney, Brown and Wahlen, 2004). The items are normally shown in a vertical format depicting the total of assets owned by the company in one half and a combined total of shareholders' equity and liabilities in other half. This forms the basic structure of statement of financial position. (see appendix 1)

2.1.3 Statement of Changes in Equity

Companies are required to prepare a statement that shows the changes occurred in the amount of shareholders' equity in a particular period of time (Wild et al., 2004). It provides a reconciliation of the opening balance of shareholders' equity at the beginning of the period with the closing value of shareholders' equity at the ending period (See appendix 1).

2.1.4 Statement of Cash Flows

The cash flows statements portrays the sources of flow of cash in a particular period. It shows the amount of cash inflows as well as cash outflows along with the sources. These statements consists of related information about the financing investing, and operating procedures of the company. The statement is made in a vertical form which starts from cash yielded from operational activities and afterwards adding the cash generated from investing and financing activities of the company.

2.2 Calculation and Interpretation of Financial Ratios

Financial ratios are calculated for the purpose of carrying out the analysis of financial information contained in the financial report. Accounting ratios include liquidity ratios, profitability ratios, financing ratios, and activity ratios. A brief interpretation of the ratios calculated is provided below.

2.2.1 Current Ratio

Current ratio shows the liquidity of the company. For calculating the current ratio, the current assets are divided by the current liabilities. It can be seen from the calculation provided below that the current ratio is 17:1 which means that the company has current assets of \$17 against each dollar of current liability. This shows that the liquidity position of the company is very good.

Current Assets	480,544
Current Liabilities	27,837
Current Ratio	17

2.2.2 Debt to Equity Ratio

The debt to equity ratio of company shows the level of debt as against the equity of the company as shown in the balance sheet. The ratio is calculated by dividing total liabilities by shareholders' equity. It can be seen from the calculation that debt to equity ratio is 0.0868. This ratio is low and it is actually good for the company as the company has to pay a fixed amount of interest on its debts.

Total Liabilities	105,679
Shareholder Equity	1,217,732
Debt to Equity Ratio	0.0868

2.2.3 Net Profit Margin

The net profit margin ratio shows the percentage of revenue that has been converted into net profits for the company. It absorbs the effects of all expenses. By dividing the net operating income by sales will give the net profit margin. It can be seen from the calculation that net profit margin is 0.0546. This ratio is quite low and it is not in the favour of company as the ratio shows a deduction of too many operational expenses.

Net Operating Income	181,075
Sales	3,315,938
Net Profit Margin	0.0546

2.2.4 Debt to Assets Ratio

The percentage of debt that can be covered by the assets of the company is determined by debt to assets ratio. The ratio is calculated by dividing total liabilities by total assets. It can be seen from the calculation that debt to assets ratio is 0.087. This ratio is quite low and it is good for the company as the ratio shows that there is not much debt acquired by the company.

Total Liabilities	105,679
Total Assets	1,217,732
Debt to Assets Ratio	0.087

The ratios discussed above help managers in taking strategic decisions regarding the operations of the business. Current ratio let managers decide about the working capital requirements as well as the liquidity requirements of the company. Debt to equity ratio helps

managers to make judgments and take decisions regarding the acquisition of credit. Debt to assets ratio assists managers in analysing the strength of repayment of loans of the company.

Task 3

3.1 Long and Short Term Financing for an Organization

In order to operate a business, it is essential for companies to attain financing. There are mainly two types of financing that a company requires which includes long term and short term financing. Long-term and short-term financing are two different aspects and have distinguished characteristics. The two forms of financing are distinguished due to the time period for which financing is required or the debt repayment time scale. Short term financing is considered as a financing that is provided for a time period of one year to maximum. As this type of financing is provided for a short period of time, the interest rate acquired is relatively low as compared to the long term financing. The following type of financing has a low risk attached to it due to which it is easy for small or growing companies to access financing (Chittenden, Hall and Hutchinson, 1996). There are various types of short term financing which includes short term loans. The main aim of acquiring short term financing is to pay for short term expenses such as wages, operating expenses, working capital and many more.

On the other hand, long term financing is acquired for a long span of time, mainly more than 3 and up to 30 years. There is high risk attached to this type of financing as it attained for a longer period of time due to which interest rate charges is relatively high and requires collateral in order to attain the financing. The main reasons due to which

companies can acquire long term financing would include investing in projects, purchase of machinery or land, acquiring a business and many more. The type of financing that a company needs to attain depends upon the nature of the business and its short/long term aims and objectives.

3.2 Sources of Short Term and Long Term Finance

Finance for the business can be obtained from number of sources. These loans are categorised according to the time of repayment as short term or long term loans. The type of loan acquired depends on the financing needs of the business (Peirson, 2014). The sources of acquisition of loans are described below.

3.2.1 Short Term Finance

Short term finance is acquired for a period of less than or equal to 12 months. The sources of short term finance include:

1. Commercial Paper: An unsecured promissory note with a maturity period of 1 day to 12 months.
2. Promissory Notes: A negotiable instrument which provides a promise of payment by the issuer at a fixed date.
3. Asset Based Loans: These are the types of loans which are short term and are backed by the assets of the company.
4. Letter of Credit: This is issued by any financial institution to the seller of goods. The seller undertakes that issuer will pay on his behalf to the third party buyer.

3.2.2 Long Term Finance

Long term finance is acquired by the corporations for a period of more than a year. The sources of long term finance include:

1. Equity: Company issues common and preferred stock whenever it needs long term finance.
2. Corporate Bonds: Corporate bond are issued by the company in order to collect funds for long term purposes against an amount of interest to be paid by the company.
3. Capital Notes: These are convertible securities which can be converted into shares at a later date.

3.3 Cash Flow Management

Managing the cash flows is important for every business as it reflects the performance of business. Several techniques are available for the management of cash flow which are as under.

3.3.1 Use of Technology

Technology can be used to shorten the cycle of cash conversion. With the help of electronic invoices the whole process of collection and payments can be shortened.

3.3.2 Optimisation of Financial Functions

A number of optimizing techniques are available to improve the management of cash flows. Effective practices of accounts receivables can be implemented which leads to error reduction and speedy collections.

3.3.3 Matching of Funds to Obligations of Cash Flows

Cash flow management can be made proficient if the company match the sources of funding with the capital flows.

3.4 Investment Appraisal Methods

Decision making on a certain investment is a vital element of strategic decision making for every business as investments effects future economic growth and the prosperity of a business. There are multiple elements that can influence the quality and effectiveness for an investment decision making such as the method of evaluating the project and the basis of selecting a certain investment project. In order to invest in a certain project, it is vital for the board or managers to take into account the cash flow that the project would generate. Furthermore, it is important to consider the risk and service life of an investment and an adequate return from the project.

The main aim of the systematic appraisal is to attain an effective spending decision for current and capital expenditure on the projects or programs. There are various analytical techniques which can be adopted in the process of appraisal and can be used to evaluate the investment decision. In order to have an effective appraisal for a project, it is essential to have an in-depth understanding of Net Present Value and discounting (Dayananda, 2002). On the other hand, secondary methods of appraisal that could authenticate the investment decision of a company include CBA (cost benefit analysis), IRR (internal rate of return), Cost Effective Analysis and many more.

The most effective analytical technique that could help with the appraisal of a project includes discounted cash flow which acquires the consideration of time value of money. It serves

as a vital fundamental in appraising a certain project as it is important to take into account the present values of all the benefits and costs. Secondly, the most reliable method to appraise an investment project is NPV (net present value) which allows the estimation of costs and revenue of the investment and is discounted to the present value which is compared to the initial investment. A project with a positive NPV is preferred over the project with a negative NPV.

On the other hand, discount rate is a concept which is interrelated with the NPV technique. The following method is adopted in order to convert the benefits and costs to the present value in order to determine the impact of the concept of time value of money. There are certain approaches that need to be taken into account before discounting such as weighted average method various others.

Furthermore, one of the methods of appraising an investment project is IRR which can be defined as a discount rate where the NPV of the project is equalled to be zero and indicates the internal return of a project. Moreover, apart from financial analyses, companies conduct an economic analysis that intends to assess the project from the perspective of a society. Financial appraisal takes into account the stakeholders such as investors, whereas, economic analyses emphasizes upon the non-market factors that could impact the project such as externalities.

Task 4

4.1 Ownership Structure and Corporate Governance

Ownership structure is considered to be one of the essential components for corporate governance and is influenced by various country based corporate governance elements which includes the development and emergence of stock market, laws and regulations and state intervention (LaPorta et al,1998). On the other hand, shareholder structure is diverse across countries with relatively dispersed ownership depending on the country of operations. According to de Silanes (1999), large companies in developed economies are concentrated and are operated through pyramidal groups and companies controlling various other subsidiaries, whereas, shareholders play a vital role in company's decision making and are involved in the management of a company and board meetings.

As stated by Morck, Wolfenzon and Yeung (2005), the variation in the ownership structure impacts the corporate governance in various ways. Firstly, a concentrated ownership lead to an emergence of certain new issues as the shareholders who are in minority and are in control does not share a same interest. On the other hand, shareholders that are dominant have the right and control over the disciplinary management.

4.2 Roles and Responsibilities of Stakeholders

Corporate governance emphasizes upon the right and responsibilities of the stakeholders of a company (Aoki, 2001). The concept of corporate governance is a broad dilemma and varies from region to region. For example, USA and UK are classified as by dispersed ownership where essential mechanism for corporate governance revolves around contractual incentives, legal regulation and corporate control. On the other hand, in other regions, shareholders of the

companies and the members of the family retain a greater share and are encouraged to operate with a direct control. These companies imply weak managerial incentives, high proportion of debt and limited market oriented regulations for revelations.

As shareholders emphasizes more on maximizing profit with low risk attached, managers aims to enhance growth in the company. According to Fernandez-Rodriguez et al., (2004) independent directors lead to an increase in the effectiveness of corporate governance. Ownership structure has various impacts on managerial decisions that are stated below:

- Dispersed Ownership- No managerial Intervention
- Dispersed ownership- Limited managerial ownership
- Controlled ownership- Limited managerial intervention
- Controlled ownership- No managerial ownership

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Appendix 1

ABC Company, LLC	
Statements of Operations	
For the Year Ended December 31, 2013	
	0-Jan-00
SALES	\$ 3,315,938
COST OF SALES	2,675,286
GROSS PROFIT	640,652
OPERATING EXPENSES:	
Advertising	5,264
Auto and Truck Expenses	3,686
Bank Service Charges	3,158
Credit Card Fees	16,621
Depreciation	8,436
Insurance	24,511
Legal and Accounting	15,943
Miscellaneous	10,963
Payroll Taxes	29,931
Rent	36,000
Repairs and Maintenance	34,370
Supplies	35,748
Travel	7,071
Utilities	28,338
Wages	199,537
Total Operating Expenses	459,577
OPERATING INCOME (LOSS)	181,075
INTEREST EXPENSE	6,237
NET INCOME BEFORE TAXES	174,838
INCOME TAXES:	
Current	-
Deferred	-
NET INCOME	\$ 174,838

ABC Company, LLC
Statements of Financial Position
As of December 31, 2013

CURRENT ASSETS:		
Cash		416,400
Trade Accounts Receivable		41,610
Inventory		20,234
Prepaid Income Taxes		2,300
Total Current Assets		480,544
PROPERTY AND EQUIPMENT:		
Machinery and Equipment		937,100
Less: Accumulated Depreciation		199,912
Net Property and Equipment		737,188
TOTAL ASSETS		1,217,732
CURRENT LIABILITIES:		
Current Portion of Long-Term Debt		7,000
Accounts Payable		6,830
Credit Cards Payable		14,007
Total Current Liabilities		27,837
DEFERRED TAX LIABILITY		-
LONG-TERM LIABILITIES		77,842
TOTAL LIABILITIES		105,679
MEMBER'S EQUITY		1,112,053
TOTAL LIABILITIES AND MEMBER'S EQUITY		1,217,732

ABC Company, LLC
Statements of Member's Equity
For the Year Ended December 31, 2013

	0-Jan-00	0-Jan-00	0-Jan-00
MEMBER'S EQUITY - BEGINNING	\$ 1,064,192	\$ 512,360	\$ 896,192
Net Income	174,838	0	0
Member's Withdrawals	(126,977)	(126,977)	(126,977)
MEMBER'S EQUITY - ENDING	<u>\$ 1,112,053</u>	<u>\$ 385,383</u>	<u>\$ 769,215</u>

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ABC Company, LLC	
Statement of Cash Flow	
For the Year Ended December 31, 2013	
	0-Jan-00
CASH FLOWS FROM OPERATING ACTIVITIES:	
Net Income	\$ 174,838
Adjustments to Reconcile Net Income to Net Cash Flows From Operating Activities:	
Depreciation	8,436
Deferred Income Taxes	-
Decrease (Increase) in Operating Assets:	
Trade Accounts Receivable	(11,303)
Inventory	(2,248)
Prepaid Income Taxes	(2,300)
Increase (Decrease) in Operating Liabilities:	
Accounts Payable	(3,169)
Credit Cards Payable	553
Total Adjustments	(10,031)
Net Cash Flows From Operating Activities	164,807
CASH FLOWS FROM INVESTING ACTIVITIES:	
Purchase of Property and Equipment	(172,000)
Net Cash Flows From Investing Activities	(172,000)
CASH FLOWS FROM FINANCING ACTIVITIES:	
Repayment of Debt	(17,460)
Member's Withdrawals	(26,977)
Net Cash Flows From Financing Activities	(44,437)
NET INCREASE (DECREASE) IN CASH	(51,630)
CASH - BEGINNING	468,030
CASH - ENDING	\$ 416,400