Financial Decisions

Areas in which we might be called upon to make financial decisions fall into the following categories:

1. Decisions about Capital

1a. Investment – what capital purchases to make

The issues concerned are:

- The rate of return which can be expected
- Strategic importance
- Application of profit or new inward investment
- Part of an investment plan

A useful tool is **Cost/Benefit Analysis**:
The costs of the investment are quantified. This probably includes not just the cost of a particular machine but its maintenance and upgrading over its lifetime, training, management time etc. The benefits are quantified. This may include profits from additional business, savings on time currently used, savings on outside contractors etc. There may be things that are more difficult to quantify such as reduction in stress or improvement in image to customers, but it pays to put work into placing a value on these things for comparative purposes. The amount the new investment will generate over its design life is then used to assess return on capital employed.

A similar process can be used for any investment, for instance in market research or management time spent on inventing a new control system. It is a way of trying to put a figure on the value of what we do.

1b. Borrowing – how much and from whom?

The issues concerned are:

- Is this for fixed capital or working capital?
- If it is fixed capital
    - The cost
    - Comparison with rate of return
    - Will the return also meet repayment of capital?
- If it is working capital
    - Cost to business calculated into costing structure
    - Is there any other way (credit control, advances from customers)?
    - Is it structural (is it needed for a long time or just to support a particular project or seasonal factor)?
    - Does the term of borrowing match the need?
    - How much exposure for how long?

The central issue is: is there a plan to deal with long term capital strategy and does this plan deal with accumulating a capital base under the control of the co-operative? The only way to guarantee this is to have targets for generating

profits and reinvesting in the business. The only alternative way to grow is to suck in outside investment. This may be a useful tool to use but beware of the effect on the gearing ratio. The gearing ratio concerns the proportion of the business owned by itself and the proportion owned by outsiders.

2. Budgeting Decisions

This concerns the allocation of money to cost centres. This is our estimation of the costs of business and feeds through into our pricing strategy and also our understanding of our need for working capital.

The key issues are:

- Are there good systems for feeding historical information into our estimating system?
- Are these estimates modified by research into future trends?
- Do these estimates take full account of growth targets?
- Is there a monitoring and review procedure?

A useful tool is **Sensitivity Analysis**:
Sensitivity analysis takes each budget item and assesses its significance to the business by asking the question "how big a part of our expenditure is it, and is it possible to control it in any way?" The bigger the part of the budget and the more changeable it is the more management time is justified in trying to reduce it, and the greater the risk if external factors drive it up – therefore the greater the need to monitor it closely and move our pricing structure accordingly. It is possible to generate "key indicators" which show what is happening to cost structures within a business.

Risk Analysis

Risk analysis is a process for quantifying and addressing the risks faced in the course of carrying out a particular project or of business generally.

Examples of risk include:

- Cost over-run on a project
- Customer unable to pay
- Computer system goes down
- Key supplier unable to supply
- Interest rates rise
- Exchange rates move (where contracts are in foreign currency)
- Competitor embarks on price war
- New product launched in core market

The first task is to assess impact that risk might generate and to put a figure on it; this would enable the classification of risks into small (absorbable) low management requirement, medium (significant effect on cash flow and or profitability) needs looking at, and high (survival threatening) in need of satisfactory risk management.

The second task is to look at means of minimising risks as they arise.

Examples of risk minimisation strategies include:

- Refusing contracts over a certain size
- Insisting on part payment in advance
- Tight contract monitoring and progress chasing
- Good back up systems
- High grade support contracts
- Insurances
- Hedging

The third task is to look at long-term strategies to avoid risk. Examples of such strategies include:

- Improving quality assurance and customer care
- Widening customer base through marketing and promotion
- Building reserves
- Research and development of new product
- Diversification

From the point of view of the finance worker, the cost of undertaking a particular project, new direction or increase in volume of activity is that the true costs of this should include not just the input costs should everything go right, but the costs of contingency arrangements which have to be put in place to ensure that, should things go wrong, the viability of the business is not threatened. This approach is important to ensure that the business is not always one disaster away from destruction.

The question stream is:

1. What could go wrong?
2. How can we ensure that it does not?
3. What will this cost (cost of production)?
4. If we cannot ensure that it cannot go wrong what can we do to minimise the impact?
5. What does this cost (cost of production)?