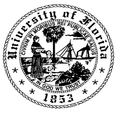
Archival copy: for current recommendations see http://edis.ifas.ufl.edu or your local extension office.



UNIVERSITY OF FLORIDA

EXTENSION

Institute of Food and Agricultural Sciences

Financial Management: Some Important Generalizations[1]

Karl Kepner and Allen Wysocki[2]

Introduction

The objectives of this article on financial management are two-fold: to provide an overview of the importance of professional financial management to a business firm's operations and to discuss nine financial management perspectives and beliefs that tend to restrict the financial performance of business organizations.

It is our belief that these introductory financial management observations are important to all managers and supervisors. 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, financial and otherwise, are immediately and/or eventually will be reflected in the financial performance of the business enterprise. At the same time, many managers, and even business owners, have had 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. At the same time, many business firms do survive for relatively long periods without satisfactory levels of profitability. For existing firms this occurs when they live off previously-retained earnings. For new firms that are established with significant financial reserves, it may take years for these original investments to be depleted. New firms that are started with limited financial reserves will obviously have a shorter life if they are unable to operate at minimum cost.

1. This is EDIS document FE 343, a publication of the Department of Food and Resource Economics, Florida Cooperative Extension Service, Institute of Food and Agricultural Sciences, University of Florida, Gainesville, FL. Published July 2002. Available on the World Wide Web at http://edis.ufl.edu.
2. Karl Kepner, Distinguished Professor, and Allen Wysocki, Assistant Professor, the Department of Food and Resource Economics, Florida Cooperative Extension Service, Institute of Food and Agricultural Sciences, University of Florida, Gainesville, FL.

The Institute of Food and Agricultural Sciences is an equal opportunity/affirmative action employer authorized to provide research, educational information and other services only to individuals and institutions that function without regard to race, color, sex, age, handicap, or national origin. For information on obtaining other extension publications, contact your county Cooperative Extension Service office. Florida Cooperative Extension Service/Institute of Food and Agricultural Sciences/University of Florida/Christine Taylor Waddill, Dean.

Archival copy: for current recommendations see http://edis.ifas.ufl.edu or your local extension office.

So, what is the minimum cost of staying in business? According to management guru 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.

Inappropriate Financial Management Perspectives

Basic generalizations regarding the current financial management practices and viewpoints of many U.S. business owners and managers can be identified. These viewpoints, when they exist, tend to restrict business firm profitability. They get in the way of management practices that can improve firm financial performance. Therefore, owners and managers need to evaluate the extent to which the following financial observations 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 generally do not recognize that profits are return-to-owner capital, just as interest is return-to-creditor capital. This 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 nor your firm has been earning profits at a level that will permit it to stay in business in the future? There are some managers (especially in production agriculture) who are prepared to pay the cost of staying in business.

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 by the firm's Operating (profit and loss) 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 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?

Archival copy: for current recommendations see http://edis.ifas.ufl.edu or your local extension office.

The Importance of Balance Sheet Accounts

Managers do not generally recognize the impact and importance of Balance Sheet accounts (assets, liabilities and net worth) in determining business profitability. Profitability is generally 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 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, as previously indicated, 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 (Figure 1). Business profitability 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 percent change in any one of these measures will result in a 10 percent 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. 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 but that many business owners and managers have the need to improve financial management professionalism. This article has identified nine financial management perspectives and 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

Druker, Peter F. (1980). Managing in turbulent times. *Colorado Business*. 7 (May): 54-55.

Archival copy: for current recommendations see http://edis.ifas.ufl.edu or your local extension office.

Keown, Arthur J. John D. Martin, J. William Petty, and David F. Scott, Jr. (2001). *Foundations of Finance*, third edition. Saddle River, N.J.: Prentice Hall.

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

Figure 1. DuPont Analysis.