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FINANCIAL MANAGEMENT | BASIC

# Video Transcription: Demystifying Financial Management



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Hi, my name is Paul and I am going to introduce financial management to you. Until now, you have probably done some financial reporting and you have also done some management accounting, and so financial management comes along and some of you might be confused. Where does it fit in between these two disciplines that I am familiar with? It is not financial reporting plus management accounting; it is actually something entirely different.

In financial management, you are going to get into the shoes of management, and are going to need to make some very important decisions. In order to give you an overview of these decisions, we are going to take a look at a diagram that gives you the big picture of financial management. And that is what I am going to be talking you through, now.

Getting into the shoes of management means understanding what decisions management needs to make. The first decision is crucial, it is: what is your idea; what are you going to do in your business; what are you going to sell; what is your service going to look like? So, the idea, your business proposition, sits in the centre. And then, once you have an idea about what you are going to do, you will need to make the financing decision. That is incredibly important and you've got this blend between debt and equity that you will need to decide upon. Once you've got your finance raised, you make your second big decision, which is the investing decision. You are going to need to buy some assets and you will need to get your business going. Once you have got your money and you have got some assets, your third decisions are all around the operations. The operating decisions try and take into account things like the sales price of the market strategy or distribution; how much you are going to pay your staff; what kind of quality control you are going to have. There are so many things that fit into one decision – the operating decision. It is actually really a multitude of small decisions that go in here.

But at the end of the day, you hope that your income exceeds your expenses so that you walk away with a profit. Once you've collected the cash at the end of the year, you can make some decisions: you can decide to reinvest that cash in the business, making it a source of finance, going into retained earnings, or you can pay that out as a dividend to shareholders, which is the fourth decision – the dividend decision. So this big picture diagram, if you just take a look at it, lets you step into the shoes of management. What is your idea? Where are you going to get your finance? What are you going to invest that finance in? How are you going to run your operations? And finally, what will you return to shareholders by way of dividend and what will be kept within the business to provide finance for your next year of operations? The diagram in the video gives you financial management in a big picture, and I hope that you can, over the next few years of your studies, understand levels within this diagram as you dive deeper into these big decisions.



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So, there is this big-picture diagram. Let me give you a little flavour for the different layers that are involved.

Let us take the first decision, the financing decision. You have got this blend between debt and equity and what you are trying to do is get that blend right so that your cost of finance is low, your weighted average cost of finance is low, but yet it does not add on so much risk that you could get yourself into trouble because you need to make a payment but you do not have the cash available. So that is what management are thinking through there. How can we get finance that is cheap but that is not too risky? Jump across to your investing decision. And here, you are trying to work out what assets are going to return for you fantastic cash flows. You want to look at those projected cash flows and only invest in assets where the cash flows generated are higher than the cash flows involved in purchasing that asset. Here, we are in the realm of valuations and capital budgeting and needing to work out, what assets are going to give you a return greater than your source of finance because that is really the key. You cannot be investing in assets that give you return that's less than your source of finance. That would be destroying value for shareholders.

The operating decision. There are so many subjects that get involved here: marketing, human resource management... I do not know what studies you are going to pursue in this area, but anything that will help you get wise with your business and get increased profit, goes in here. How management accounting fits in here is it helps you understand what fixed costs and variable costs there are, and allows you to make some wise decisions based on your contribution margins.

Finally, the dividend decision needs to always be taken into account along with the options of perhaps doing a share buy-back or paying a regular dividend, which gets enhanced by special dividend or maybe paying none at all. These are all strategic moves that management needs to consider and, in particular, needs to understand what his shareholders' expectations are.

So, you have just been introduced to the subject of financial management. It is not financial reporting and it is not management accounting; it is something entirely different. It is being in the shoes of management and needing to make these key decisions: the financing, investing and, in particular, the dividend decisions are what finance managers need to stay up at night dreaming about. And you, in the next few years of your studies, are going to get a lot more colour added to these options. But what this video has hopefully done is introduced you to step into the shoes of management and being able to evaluate, with all the layers of complexity, what would be right for the particular business that you are going to make decisions for. I hope that you look at these areas and make sure that you watch the subsequent videos that help to explain them in a little bit more detail. Financial management is such an exciting subject; it is where so much of what you have learnt can be applied in a practical business context. So, roll up your sleeves and enjoy exploring this fascinating area of the financial world.