1. What is financial management?

The first chapter introduces this book. First, financial management is defined and its role within the company explained. Second, financial objectives are discussed and third, a categorization of financial instruments is made.

1.1. The system of corporate financial management

A model enterprise will be used from now on.

Example 1 **Description of the model enterprise**

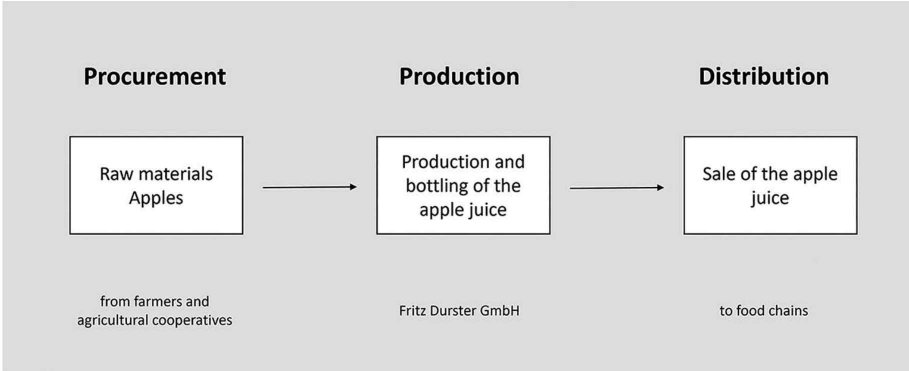
The model company Fritz Durster GmbH is based in the Mostviertel in Lower Austria. Fritz Durster owns 75% of this company and his wife Melanie Durster 25%. Melanie and Fritz Durster are also managing directors of Fritz Durster GmbH.

The object of Fritz Durster GmbH is the production of apple juice of several varieties. Apples are purchased from farmers or agricultural cooperatives, mainly from the surrounding area and pressed into apple juice. The juice is then sold under the trade mark „Dursti“ mainly to food chains in Austria and Bavaria. More recently, the juice has also been exported to the Czech Republic and Slovakia. The company has ten employees, generates a turnover of € 4.5 million per year and reports a net profit of € 300,000.

Production of services

This example intends to show how products and services are produced. Regardless of the financing, Apples are purchased. These apples must be stored and then fed into production. It is important to mention that the desired products are produced with the appropriate input of labour and machines. The produced apple juice has to be stored in some form, i.e., either in large barrels or bottles. In order to decide on the type of storage, it is essential to know to whom – and this addresses the third point – the apple juice will ultimately be sold to. This third area represents the connection to the sales markets.

Example 2 **Overview of the services provided by Fritz Durster GmbH**



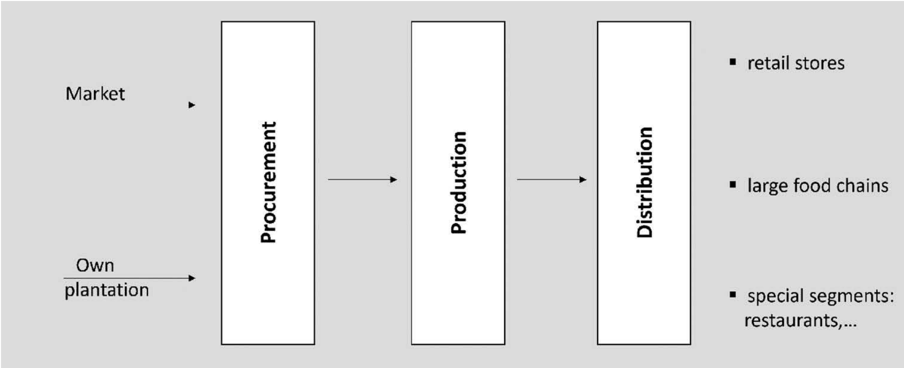
Risk Indirectly, it is worth mentioning something that will be discussed later in chapter 5.2: the **risk** taken with this activity.

Fritz Durster GmbH can basically procure apples on national and international markets. But it could also buy its own land where apples are grown in plantations. This would make it less dependent on market prices for apples, but at the same time production costs arise. There are both advantages and disadvantages to these two basic systems. In one case, the company will be affected by highly volatile **market prices** on the procurement markets, whereas in the other case the pure **production costs** will play a role, thus decoupling to a certain extent from fluctuating market prices. This is associated with varying degrees of risk, because **sales prices** do not always change to the same extent or in the same direction as in procurement markets.

An equally varied risk is presented by the **sales markets**. The company's objective may be to supply primarily natural persons using their own shops, probably at higher prices than the other alternatives, but also with higher costs. However, it could also be possible to supply a number of large food chains, which, although they purchase large quantities, have a high power in price discussions. Additionally, there is the possibility of concentrating only on individual, clear segments, e.g. catering. On the one hand, these specialised markets can be addressed in a better way. On the other hand, there will also be a greater dependence on this market segment.

To sum up, there are already various risks, which will also have corresponding financial consequences.

Example 3 **Fritz Durster GmbH with procurement and sales market risks**



Company

But what exactly is a company? The company should represent the described **entity using the appropriate legal framework.** This company can of course carry out its activities in individually defined areas, i.e., in factories or plants. Our central purpose in this book is to finance this company.

Cash flows

Financing primarily has something to do with **cash flows**. It is therefore a question of what actually happens to cash flows in the production of services as outlined above. We find that money only flows into the company when the apple juice is sold – no matter to whom. And the money flowing back to the company can be used, for example, to pay workers, energy costs, rents as well as to purchase apples that can be used as raw materials for producing goods. This means that the money actually keeps this production of goods and services going and is intended to ensure the functioning of the company. The impressive thing is – if this cycle works – that the inflowing amount of money is at least as high as the outflowing amount of money.

However, one factor still needs to be taken into account, namely the **state**.

Subsidy

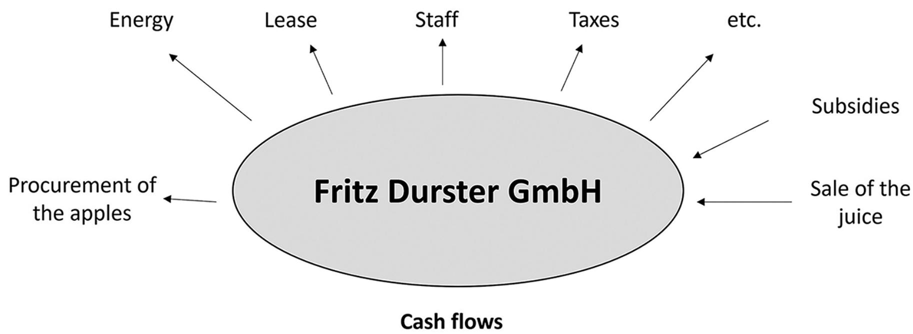
The state or local authorities may intervene in a way that is positive for the company, for example by granting **subsidies.** These may consist in the availability of capital from local authorities in order to guarantee a certain orientation, a certain performance of the company. This means, for example, that a certain **offer** is made, which would not otherwise have been made under market economy conditions. However, the influence within the framework of a subsidy could also go as far as selecting a specific **location** for the provision of services, i.e., that certain funds are made available so that this provision of services takes place in municipality A and not in municipality B. It is also possible that this capital does not flow directly as money, but rather „indirectly“, i.e., that no specific amount of money is made available, but rather an object (e.g., a piece of land) that saves the company the outflow of money. These and many other possibilities are rather exceptional cases and will not be considered in more detail in the further discussion. They lead, in one way or another, away from the pure **market economy mechanism,** because there are higher-level considerations (e.g., social) in this context.

While subsidies only play a role in special cases and occasionally, outflows of financial resources to the state through taxes play a role that **every** company has to expect.

Taxes The issue of **taxation** is further dealt with in a very limited and rudimentary manner. However, it should be noted that taxes can have a significant impact on financial decisions.

Summary If it is now summarised that the financial model of Fritz Durster GmbH is very closely related to cash flows and that the state must also be taken into account, then the following first basic model would be described.

Example 4 **Financial model picture of Fritz Durster GmbH without external financing**



This simple cycle can probably no longer work if the company needs a new apple press, for example, because the old one can no longer be used. The purchase of this new machine requires relatively high financial resources, so that in the cycle described above there may not be enough resources available to purchase it. Therefore, it will be necessary that money flows into the company from outside – and not just by sales.

External financing This is the case for **external financing.** People from outside the company „pump“ money into the company in special financing acts and not, as in the past, by purchasing apple juice. For the natural or legal persons who provide external capital, it applies – as in the rest of the process – that a return is expected. The expected return will vary depending on the legal status or the risk taken by the investor, the agreed duration of the commitment, etc.

Basic model Thus, from the simple **basic model**, the following can be stated:

A company is understood to be the institutional legal entity in which the services are provided.

- The company is profit-oriented.
- Corporate financing is primarily concerned with cash flows that flow into the company (inflows) and those that flow out of the company (outflows).
- These cash flows (inflows) are directly related to the provision of products and services (e.g., from the sale of apple juice).
- These inflows cover claims arising from others (outflows) such as wages/salaries, payments for energy, rent, the purchase of apples etc.
- Thereby the state as a player along with subsidies on a case-by-case basis and taxes on a regular basis has to be considered.
- If additional money is required, it flows into the company through individual financing acts and not in return for the services provided. Compensation must always be given for the „use" of this money (which is needed, for example, to purchase the new press line). However, the compensation required depends on the legal status of the investor and the duration of the provision.

This simple model is now being extended:

Investment

If money is converted into long-term assets, e.g., into the aforementioned pressing plant or into the purchase of shares in another fruit juice company, this is called a corporate or capital expenditure **investment**. Decisions on the use of these financial resources can also be seen in a broader perspective as part of the issues of corporate financing.

The question of **which** new press line is invested in or whether it is better to refrain from investing **at all,** is an important issue. Besides, the question **which** investment opportunity is part of corporate finance. It is highly probable that the investment alternatives discussed will differ in the money required for the purchase as well as in the duration of use, expenditures on production, etc., and will therefore often have a considerable impact on the company's profits.

Capital Budgeting

These questions are addressed within **capital budgeting** (chapter 4). This is not a specific type of calculation or „system" such as accounting, but rather various instruments for helping in decision-making. The more comprehensive the calculation models are, the better they take into account the real situation of the company or the environment.

Disinvestment

If there is an investment, then there is also the opposite of an investment, called **disinvestment** or **divestiture.** It is about assets that are tied up in the company in the long term being **converted back into money** and thus leading to an extraordinary flow of money into the company. This is the case when the pressing plant is sold again because it has proved to be „impracticable" or an unused piece of land is sold.

Reasons for disinvestment

A basic distinction must be made between whether this is done in an **„emergency" situation**, i.e., if Fritz Durster GmbH has problems, e.g., paying the salaries of its employees on time, and therefore sells a property under time pressure.

It will probably do so below market value, as the first buyer for the land must be accepted. From this point of view, a disinvestment in the company must of course be viewed negatively.

If, on the other hand, such a decision follows careful considerations, for example, to sell the unprofitable plot of land in order to reinvest the gained money in other investment projects with higher returns, then it is obvious that such a strategy should be considered reasonable. The basis of this transaction is therefore proper **planning**.

Therefore, disinvestment can be „good“, but also „bad“ for the company.

Financial management: definition

As a result, we define financial management the following way:

Financial management consists of all issues related to cash flows.

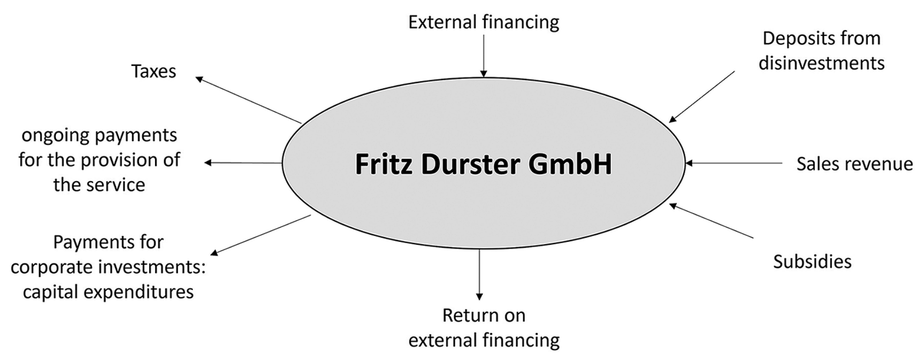
This means the procurement of cash, short and long-term decisions on their use and the resolution of issues relating to investments and disinvestments. This also includes planning and controlling the financial flows within the company and risk management. There are close links to management accounting, but also to financial accounting and taxes.

This does not include **private** investment decisions.

In a nutshell, one could say that **financial management is the financial leadership of a company.**

Financial management has to pursue certain objectives, as decisions can have positive or negative effects on the company.

Example 5 **Financial management of Fritz Durster GmbH**



Cash flows

1.2. Financial management goals

1.2.1. Maintenance of liquidity/solvency

The financing issues of a company are not an end in themselves, but „right“ decisions in this area should enable the further (trouble-free) operating process in the company.

Solvency

An essential point here is the maintenance of **solvency**, i.e., that the company is in a position to meet all payment obligations (e.g., to suppliers, employees) in a timely manner and in full, i.e., in accordance with the agreements. This is the only way to ensure smooth cooperation with all partners of the company.

Insolvency

In addition, there is also pressure from the legislator: according to § 66 of the Austrian Insolvenzordnung (IO), the **inability to pay** is a reason for opening insolvency proceedings (reorganisation or bankruptcy proceedings). This massively impairs the company's continued existence and probably represents one of the greatest, if not the greatest, risks for the company. Insolvency means that, for lack of sufficient financial resources, the company is **permanently unable to** pay its due obligations and is unable to obtain these funds quickly.

Suspension of payments

If there is only a **payment hold-up** („liquidity bottleneck, payment squeeze“) that can be overcome „soon“ (usually in a maximum of three months), this does not lead to the above consequence. At the very least, however, the company has suffered a loss of trust among its business partners.

Therefore, it is clear that the state of insolvency must be prevented at all costs. This can be achieved by paying extensive attention in financial management to the existence of **„sufficient“ liquidity**. All considerations, planning and decisions must focus on this.

„Sufficient" liquidity

But what is „sufficient“ liquidity? It is often not possible to exactly predict the inflow of money, as customers often pay late or even go bankrupt. In addition, an expected promise of money may not come true because, for example, a loan is not granted at the decisive moment. Similarly, outflows – e.g., as a result of a court decision that is negative for the company – cannot be specifically estimated.

Because of this uncertainty, management and planning (cash budgeting; see chapter 5.1.1.) must be carried out with **caution** so that the aforementioned sufficient cash is available when it is needed.

1.2.2. Value Management

A second fundamental principle has much to do with financial management:

Why does a company exist or what interests does the owner(s) have?

Of course, it is pleasant, if the products or services of the company are appreciated, if the company has a high market share in the industry, if there is a high level of customer satisfaction and if corresponding quantities can be sold, but in the end only the highest possible **return of the money invested** can be accepted as the ultimate goal of a company. As a key ratio, the profit or cash flows determined by the accounting department are compared with the amounts of money invested.

Profitability

One speaks of the so-called **profitability** ratios. The higher these rates of return are in comparison with those of other companies, the higher the **value of the company** in relation to its competitors will be, because the company is more efficient than its competitors.

$$\text{Return on equity} = \frac{\text{Profit}}{\text{Equity}} \times 100$$

$$\text{Return on assets} = \frac{\text{Profit + interest on borrowings}}{\text{Total capital}} \times 100$$

$$\text{Return on sales} = \frac{\text{Profit}}{\text{Sales}} \times 100$$

Note: The results are usually given in percentages.

Increase in value

The profitability of a company can be higher than in other comparable companies, for example, due to better motivated employees and/or better combinations of performance factors (e.g., machines are used more efficiently). The objective is thus to increase the value of a company from the shareholders' point of view (value of the whole company minus debts). This is referred to as **value creation**, **value management** or **Shareholder value orientation** (see chapter 5.4.1.)

The financial management of the company must strive to achieve the highest possible return on the money or capital invested and made available to the company on a permanent basis. However, the risks taken must be considered.

Example 6 **Extract from the Annual Report of Wienerberger AG 2020**

Wienerberger's value management focuses not only on long-term, sustainable creation of shareholder value, but also on ESG aspects with a special focus on the wellbeing of our employees, whose contributions are essential for the company's long-term success. In our separate NonFinancial Information (NFI), we report on progress achieved in terms of our non-financial performance. The key indicator of Wienerberger's value-oriented corporate governance is the return on capital employed (ROCE after tax). This indicator measures the after-tax return on capital currently employed in the company and reflects the value creation by the individual business units and by the Group as a whole. It is calculated by relating the net operating profit after tax (NOPAT) to the average interest-bearing total capital employed of the Group. Wienerberger's medium-term target is to sustainably increase its ROCE to more than 10%. In addition to ROCE, other indicators are also

> regularly analyzed as part of the company's value management and taken into account in the calculation of top management bonuses, such as free cash flow, cash flow return on investment, and total shareholder return. Under the impact of the Covid-19 pandemic, ROCE dropped below this medium-term target. Despite temporary plant closures driven by government-imposed measures to contain the pandemic, Wienerberger generated strong operating earnings before interest and tax (operating EBIT) in the amount of € 305.1 million (2019: € 362.7 million). This resulted in NOPAT of € 244.4 million (2019: € 297.4 million). Driven by impairments, negative foreign exchange effects and the disposal of our Swiss operations, average capital employed dropped to € 2,753.1 million, as compared to the previous year's value of € 2,802.2 million. Overall, the Wienerberger Group's ROCE came to 8.9% (2019: 10.6%).
>
> [Annual Report 2020 (www.wienerberger.com)]

However, this leads to a contradiction with the above mentioned objective of achieving a high level of liquid assets, as these undoubtedly cannot be invested at a high rate of return because they must be available in the short term. This dilemma cannot be solved with a formula or other rules, but rather it is the task of the financial management to find a balance. Generally speaking, if you are more willing to take risks, more attention will be paid to profitability as a criterion; if you are more stable and risk-averse, more attention will be paid to liquidity.

1.2.3. Ensuring right decisions

Rational action

Decisions are „right" if they take into account the overall objectives (liquidity and profitability) in the background and if rational management actions can be assumed. The management acts rationally if it knows the financial and economic context (which is assumed here), has all relevant information and does not let any secondary objectives influence these basic considerations.

If, for example, shareholders are also responsible for making the daily financial decisions, then „right" decisions can be assumed. They have all the necessary information and no other goals than to be successful in business.

What may work in a **small company** is difficult to imagine in a large **listed company.** For example, the individual small shareholder of OMV AG cannot and do not want to take over the financial management of the company. It would also be completely impossible to consult the shareholders on „day-to-day" financial decisions. Consequently, the shareholders have entrusted a management (board of directors) with this task (see chapter 3.1.2.2.).

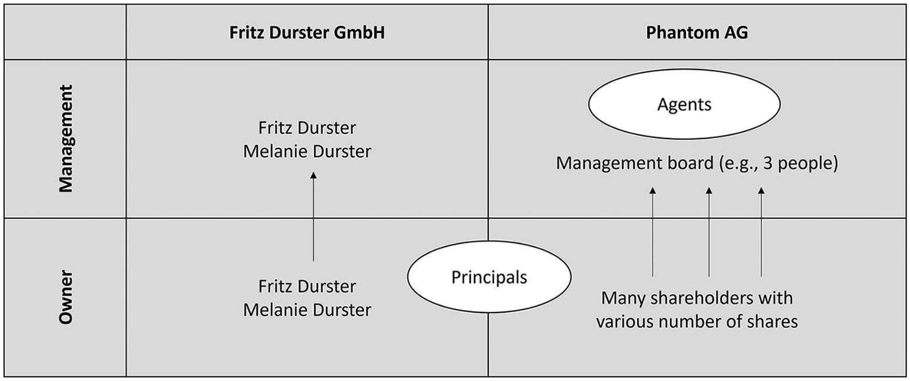
Information asymmetry

Now, however, the case occurs that the members of the board of directors and in particular the CFO know more than the „ordinary" shareholders – the information is therefore not distributed evenly (symmetrically) but unevenly (asymmetrically). This is called **information asymmetry**. This would not be a problem as such, but there is a great risk that decision-makers will **use** this privileged position to further their **interests**. This can happen to the detriment of shareholders. Examples include unnecessary business trips, luxurious offices or measures that lead to better remuneration of management without any advantage for the owners. However, there are again a number of measures which can be fundamentally disciplinary (e.g., limiting the scope for action) or motivating (e.g., via remuneration systems) in order to align the interests of management with those of the owners. In practice, such motivations constitute bonuses or rights to subscribe to shares (so-called „stock options“); however, if such benefits are excessive or are granted in the absence of exceptional management performance, owners are equally harmed.

Agency Theory

In business administration this is seen as an agency problem, since the owner **(principal)** instructs a person to act on his behalf **(agent)**.

Example 7 **Agency problems of Fritz Durster GmbH and the listed Phantom AG**



Behavioral Finance

In addition, there may also be a risk that financial decisions are **not** taken **rationally** because the persons concerned are not in a position to do so simply because of their behaviour. Although these effects discussed in the financial literature primarily relate to decisions on the stock markets, they also have an impact on the financial management of companies. Examples can be different perceptions and processing of information as well as emotions and attitudes that influence decisions. **Behavioral Finance** is a young branch of research in the field of financial economics.

Example 8 **Behavioral Finance at Fritz Durster GmbH**

Fritz and Melanie Durster have suffered substantial losses due to the non-performance of contractual obligations by a business partner in Hungary. Due to this personal negative experience, they excluded Hungary when considering various expansion options.

Forms of financing

The basic objectives of a company's financial management have now been outlined. Important specific topics in this regard are discussed in chapter 5.