



## Module 2

### Financial Management in tourism companies

#### Lesson 3- Introduction to the theory and practice of financial management tools

### 1.1.- INTRODUCTION TO THE THEORY OF FINANCIAL MANAGEMENT

#### 1.1.1.- Accounting Facts: Pre-financial management systems

From the moment a company is created until it disappears, an "economic process" takes place within the company that develops continuously, without stopping at any time.

Parallel to the "economic process" is the "accounting process" that captures and represents it.

However, the accounting process does not run continuously and without interruptions as the economic process does, but rather accounting has artificially introduced interruptions. These interruptions are used to simulate the paralysis of the company's activity in order to provide periodic information to the users of accounting information so that they can use it in their decision making.

If these "interruptions" were not made in the development of the life of the company, it would not be possible to provide information on the progress of the company until it was dissolved. At this point, the initial assets would be compared with the final assets and the consequences of the development of the activity would be seen, but by then (end of the life of the company) the information would be of little use.

Therefore, in order to periodically establish the assets of a company and the result obtained, and to be able to report on them, the life of the company is divided into financial years or accounting periods of equal duration. The set of accounting operations that take place in a period is called the "accounting cycle".

The "accounting cycle" begins with the first transaction of each period, and ends with the preparation of the financial statements (annual accounts). Its usual duration is one year, mainly for legal reasons.

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The economic reality of the company is reflected in documents such as invoices, delivery notes, bank statements, staff salaries, etc. These documents are studied, interpreted and evaluated during the so-called pre-accounting analysis.

After this analysis, the operations are recorded, i.e. the economic event is given accounting form in the document. This part is called "Bookkeeping" and is carried out in the obligatory books in which the accounting representation has traditionally been developed.

In summary, the accounting process to be followed, using the double-entry method, would be:

- a) Opening of the accounts.
- (b) Representation of the operations of the period.
- c) Determination of the profit or loss for the year.**
- d) Adjustment.**
- e) Closing the accounts.**

The process that includes the Financial Management is established from the section c) shown in the previous paragraph.

### 1.1.2.- Financial Management Tools

The company's assets and their variations:

DEFINING TOTAL SHAREHOLDERS' EQUITY:

- Group of elements of a positive nature:
  - Assets: these are all the productive factors and elements that the company uses to achieve its objectives.
  - Rights: These are given in those situations in which the company is in a position to receive, normally money.
- Group of negative elements:

Obligations: these are payment commitments made.

Explanatory diagram of equity and net worth:

GOODS + RIGHTS = EQUITY

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$$(\text{GOODS} + \text{RIGHTS}) - \text{OBLIGATIONS} = \text{NET WORTH}$$

From an accounting point of view:

$$\begin{aligned} (\text{GOODS} + \text{RIGHTS}) &= \text{NET WORTH} + \text{OBLIGATIONS} \\ \text{ASSETS} &= \text{NET WORTH} + \text{LIABILITIES} \end{aligned}$$

In addition, other fundamental tools appear in both Accounting and Financial Management:

- Balance sheet: it represents the patrimonial situation of an entity at a given moment. It consists of the relation of goods and rights in favor of an economic unit, and its debts.
- Profit and Loss Account: it includes the income obtained by an economic unit and the necessary expenses incurred to obtain it during a certain period of time, resulting by difference in the net result of the year (profit or loss).

### 1.1.3.- Assets and Equity:

All the elements and assets shown below are also key concepts in financial analysis.

Assets:

- **ASSETS:** goods, rights and other resources economically controlled by the company, resulting from past events, from which the company is expected to obtain benefits or economic returns in the future.
- **LIABILITIES:** present obligations arising from past events, for the settlement of which the enterprise expects to release resources that could produce future economic benefits or returns.
- **NET WORTH:** the residual part of the company's assets, after deducting all its liabilities. It includes the contributions made, either at the time of incorporation or at a later date, by its partners or owners, which are not considered liabilities, as well as the accumulated results or other variations that affect it.

Net worth can be classified into three groups:

- o Equity.
- o Valuation adjustments.

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o Grants and donations.

- **REVENUES:** increases in the company's net worth during the financial year, provided that they do not originate from contributions, whether monetary or otherwise, by shareholders or owners.
- **EXPENSES:** decreases in the net worth of the company during the financial year, provided that they do not originate from distributions, monetary or otherwise, by the partners or owners, in their capacity as such.
- **THE ACCOUNTS, AS A REPRESENTATION OF EQUITY:** an accounting instrument to reflect the initial situation and the variations that subsequently occur in each equity element.

Equity:

ASSET CLASSIFICATION:

- Non-current assets: elements destined to serve in a lasting way in the activities of the company.
- Current assets: assets that are expected to be sold or consumed in the normal operating cycle (if not identifiable, in less than one year).

CLASSIFICATION OF LIABILITIES:

- Non-current liabilities: debts and obligations of the company with a maturity or extinction of more than one year.
- Current liabilities: expected to be settled (paid) in the normal operating cycle (if not identifiable, in less than one year).

## 1.2.- INTRODUCTION TO THE PRACTICE OF FINANCIAL MANAGEMENT

Once we are in place or have reached the final balance sheet, the following steps and tools are established for Financial Management:

MANAGEMENT FUND = Current Assets - Current Liabilities

If the working capital is positive, it means that the company finds itself in an economic - financial equilibrium, since it complies with the golden rule of financing, which tells us that Net Worth and Non-Current Liabilities must cover Non-Current Assets and a reasonable part of Current Assets.

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If it is negative, it means that the company is not in economic-financial balance. Since it does not comply with the golden rule of financing, which tells us that the Net Worth and Non-Current Liabilities, must cover the Non-Current Assets and a reasonable part of the Current Assets.

### GRAPHIC REPRESENTATION OF THE BALANCE:

Example: Total = 74.567 (Results obtained from the Balance of the Situation)

74.567 ----- 100%  
29.467 ----- x%

ACTIVO <b>ASSET</b>		PASIVO <b>LIABILITY</b>	
NON CURRENT ASSET	ACTIVO NO CORRIENTE = 29.467 ----- 39,52%	PATRIMONIO NETO = 54.821,90 ----- 73,52%	shareholders' equity.
	ACTIVO CORRIENTE = 45.100 ----- 60,48%		non-current liability
CURRENT ASSET		PASIVO NO CORRIENTE = 1.110 ----- 1,47%	
		PASIVO CORRIENTE = 18.645,10 ----- 25,01%	current liability
TOTAL = 74.567		TOTAL = 74.567	

Moreover, as the result is positive, the company should have no problem paying its debts at c/p.

(In case of a negative result, this explanation would be the opposite).

The procedure then requires the economic and financial analysis to be carried out, as well as the commentary of each one of them, that is going to come defined according to what is obtained in its results.

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## FINANCIAL ANALYSIS:

General Liquidity Ratio = A.C. = result > 1.8 - 2

P.C.

1st- The company has (result) u.m. of goods for sale, stocks, debtors, financial investments and cash, for each monetary unit at c/p.

2nd - In principle, by giving us a higher than standard ratio, the company will have an excess in some Equity of the Current Assets.

If the result is between 2 and 1, you can pay, but you may have trouble paying what you owe.

If the result were <1, you would be in a situation of insolvency or, in suspension of payments or bankruptcy, since you can not meet your debts in the short term.

**Immediate Liquidity Ratio = A.C. - Assets held for sale - Existing = result > 1 -1.5**

P.C.

1st - The company has (result) u.m. of debtors, financial investments and cash for each u.m. of debt at c/p.

2nd - If the company's ratio is above the normal one, it could have an excess of either debtors or cash and generally, it can face the payment of its debts to c/p.

If the result is less than the standard, the company could have problems paying its debts on a cash basis.

(Bear in mind that if it is the excess in terms of the result obtained, because of stock, what would have to be done is to sell it).

**Acid Test Ratio = A.C. - Goods maintained for sale - Existing - Debtors = result > 0.5 - 0.8**

P.C.

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1° The company has (result) u.m. of financial investment and treasury for each u.m. of debt at c/p.

2° When a result higher than the standard is produced, there is surely an excess in treasury. Generally, they should not have any problem paying their debts on a p.c. basis.

If it were below the standard, they may have issues for the payment of the debts to c/p.

**Treasury Ratio = Treasury almost equal to 0.2**

**P.C.**

1st - The company has (result) u.m. of treasury for each u.m. of debt at c/p.

2nd - When giving us above the standard value, we could suppose that the company could be losing profitability, by not investing in other capital that produce a greater profitability, for example: financial investments. It does not seem to present problems for the payment of debts at c/p.

If it presents a result quite close to 0.2, there does not seem to be a very marked excess in cash, although it does not seem to present problems for the payment of its short term debts either.

If the result is below the standard, the company could have problems paying its debts on a p/a basis.

**Debt ratio = Liabilities (P.N.C + P.C) almost equal to 0.5**

**P.N.**

1st - The company owes for each euro of the N.P., (result) u.m.

2nd - If the result is lower than the normal ratio, the company is not very indebted.

If it is higher, the company will resort to the credit of others.

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**Solvency ratio = Total assets almost equal to 3**

### **Liabilities**

1° For each euro of Total Assets, there is a debt of (result) u.m.

2° By obtaining a result greater than the standard, it means that the company is little indebted and would not have to have problems for the payment of its debts to c/p being solvent.

If the result was lower than the standard, the company would be in debt.

### **ECONOMIC ANALYSIS:**

**Economic Profitability = Operating profit x 100 = result %.**

#### **Total Assets**

The profitability result should be compared to that of other companies, to what the bank gives, etc.

The higher the result, the better the profitability.

**Financial Profitability = Net Result After Taxes x 100 = result %.**

#### **Own Funds or P.N.**

For every 100 euros invested in the company, net profit of (result %) will be obtained. The result should be compared with the competition or with the individual earning with shares in the stock market.

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### **GENERAL COMMENT ON THE SITUATION OF THE COMPANY:**

From the financial and economic analysis, we can conclude that the company is in economic-financial equilibrium (if it is negative, no), since the Working Capital Fund is positive, or it indicates this to us by complying with the golden rule of financing.

From the financial analysis, we have detected excesses in the capital, more specifically in stocks and treasury (depending on where we find these excesses, they can also be in the debts to be collected, etc.). The latter mainly implies a decrease in profitability, since the company could invest in more profitable masses, for example: financial investments.

As for the debt and solvency ratio, we can conclude that the company does not resort to credit from others (or does resort to it, depending on the result of the ratio), so the growth of the company could be limited by this circumstance (we would be talking about the so-called "financial leverage").

As for the economic analysis, we cannot express our opinion, since the company has made losses in the current financial year. If it had not, and we had obtained profits, we can say whether they are high or low, if they are compared with similar profits to our company, with general indexes.

\_\_\_\_\_(This comment will depend and vary according to the results obtained in the ratios) \_\_\_\_\_

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