1 The financial management function

The following topics are covered in this chapter:

- The nature and purpose of financial management
- Corporate strategy and financial objectives
- Stakeholder objectives and conflicts and the role of management
- Not for profit organisations

1.1 THE NATURE AND PURPOSE OF FINANCIAL MANAGEMENT

LEARNING SUMMARY

After studying this section you should be able to:

- explain the nature and purpose of financial management
- explain the relationship between financial management and financial and management accounting

KEY POINT Financial management is concerned with acquiring and using financial resources in both the short and long term, to ensure the objectives of an enterprise are achieved.

Financial management decisions involve three key areas:

Investment – both long-term investment in non-current assets and short-term investment in working capital

- **investment appraisal** considers the **long-term** plans and identifies the right projects to adopt
- **working capital management** is concerned with the **short-term**, i.e. the management of liquidity

Finance – from what sources should funds be raised?

Identification of the most **appropriate sources** (both long and short-term)

Dividends – how should cash funds be allocated to shareholders and how will the value of the business be affected by this?

Making decisions on:

- whether to **return** any cash to the owners in the form of **dividends**, or
- **retaining** some or all of the cash for **reinvestment**

The three key areas will consider:

- the organisation's **commercial and financial objectives**
- the broader **economic environment**
- the potential **risks**.

An understanding of these three key areas is fundamental for the exam

Financial roles

KEY POINT Financial management should be distinguished from other important financial roles.

Management accounting	Providing information for the **day to day** functions of **control and decision making**, for example overhead apportionment and variance analysis
Financial accounting	Providing information about the **historical** results of an organisation for **owners and other stakeholders**, for example calculating depreciation and identifying accruals
Financial management	The **long term** raising of **finance** and the **allocation and control** of **resources**, for example examining the proposed expansion plans of a business

1.2 CORPORATE STRATEGY AND FINANCIAL OBJECTIVES

LEARNING SUMMARY

After studying this section you should be able to:

- discuss the relationship between financial objectives, corporate objectives and corporate strategy
- identify and describe a variety of financial objectives

KEY POINT Objectives and targets define what an organisation is trying to achieve. Strategy considers how.

Corporate objectives – the overall mission of an organisation is broken down into commercial goals

These are set by the top-level management of an organisation.
For example, to improve the brand awareness.

Corporate strategy – how the corporate objectives will be achieved

Senior managers will decide how to achieve the corporate objectives.
For example, entering a new market.

Financial objectives – the objectives of an organisation that can be measured in monetary terms

For example, to improve profitability by 5% compared to the previous year

Corporate strategy decisions and financial objectives are set at the top of an organisation and are **filtered down** to ensure all parts of an organisation are working to achieve the same goal:

- **business level** – the overall organisation split into separate business units
- **operational level** – the day-to-day operations of business units

Financial objectives

KEY POINT A fundamental financial objective of an organisation is the maximisation of shareholder wealth. The three key decisions (investment, finance and dividends) should be adhered to when considering this objective.

Shareholder wealth maximisation – the primary objective of most organisations is to increase the net worth of its shareholders

This can be achieved by increasing the share price and/or a dividend pay-out.

Profit maximisation – the ability of an organisation to achieve the maximum profit with minimum expenditure

There may be a conflict between long and short-term goals. For example, cutting discretionary spending may increase short term profits but have a negative impact long term.

Earnings per share (EPS) growth – earnings per share is profit divided by the number of shares and growth shows how it has increased over a period of time

The disadvantage is that it does not represent the income of the shareholder.

When examining financial objectives, a distinction must be made between **maximising** and **satisficing.**

DEFINITION **Maximising -** seeking the maximum level of returns, even though this might involve exposure to risk and much higher management workloads.

DEFINITION **Satisficing -** finding a merely adequate outcome, holding returns at a satisfactory level, avoiding risky ventures and reducing workloads.

For example, an organisation might seek to **maximise** the **return for shareholders** and **satisfy** the **requirements of employees.**

Do you understand?

1 The financial manager of an organisation will make the following three decisions:

A investment, economic, dividends

B investment, finance, dividends

C economic, finance, investment.

2 Implementing a just in time (JIT) inventory system is a financial objective?

Yes or No

3 The purchase of three new machines for £300,000 each is:

A a business level financial objective

B a business level strategy

C a corporate level strategy.

1 B. The three key areas a financial manager will make decisions on are investment, finance and dividends

2 No. Implementing a JIT system is a strategy (at operational level)

3 B. The purchase of the machines is a business level strategy, i.e. how an objective can be achieved.

1.3 STAKEHOLDER OBJECTIVES AND CONFLICTS AND THE ROLE OF MANAGEMENT

LEARNING SUMMARY

After studying this section you should be able to:

- identify the range of stakeholders and their objectives
- discuss the possible conflict between stakeholder objectives
- discuss the role of management in meeting stakeholder objectives
- understand and apply agency theory
- explain ways to encourage the achievement of stakeholder objectives

Stakeholders are wide ranging groups with a vested interest in an organisation, they may be internal, external, or connected to the organisation. Management must balance the needs and objectives of all stakeholders to avoid conflict as **each group are focused on furthering their own interests.** Stakeholders include:

Internal:	
Employees	maximising employee salaries will result in lower returns for investors
Managers / directors	may follow their own aims and goals, at the expenses of other stakeholders, for example short term profits to achieve higher bonuses
Connected:	
Equity investors	the primary objective of an organisation is the maximisation of shareholder wealth and it must compete with risk free investment opportunities such as government securities which investors could turn to if they are not satisfied
Customers	satisfaction of customer needs is achieved through value for money products, this could be at the expense of profit
Suppliers	need reassuring that they will be paid in the short term and retain regular business in the long term
Finance providers	the primary interest is the repayment of debt and interest in both the long and short term and they prefer low risk policies to ensure payments are made
External:	
Government	political interests include increasing exports, financial interests include maximising taxation
The community	environmental expectations of the community at large include the consideration of fuel emissions, their legal and social responsibility expectations are, for example employee welfare

The role of management

KEY POINT **Management (or directors) are appointed as agents on behalf of shareholders to perform tasks on their behalf.**

Management are uniquely placed to pursue their own interests rather than those of the shareholders, as they are usually left alone on a day to day basis.Examples include:

- Setting their own levels of **remuneration**
- **Empire building**
- **Creative accounting,** such as not depreciating non-current assets
- **Off balance sheet financing,** where the method of funding is not recorded in the balance sheet
- Defending the organisation against **takeover bids**
- Carrying out **unethical activities.**

KEY POINT **Agency theory is concerned with resolving problems that can exist between principles (for example shareholders) and their agents (for example managers).**

Problems can be resolved by achieving goal congruence.

DEFINITION **Goal congruence –** all the operations of an organisation work together to achieve its goals

Achieving stakeholder objectives

Ways to help ensure that managers take decisions which are consistent with the objectives of stakeholders are:

Managerial reward schemes are one way of helping to ensure that managers take decisions which are consistent with the objectives of shareholders. They must be carefully designed to encourage goal congruence.

Examples include:

- Remuneration linked to **minimum profit levels**
- Remuneration linked **to economic value added (EVA),** the increase in the value of shareholder wealth in a period
- Remuneration linked to **revenue growth**
- **Executive share option scheme (ESOP**), this encourages managers to maximise the value of shares

A set of voluntary principles called **corporate governance codes** have been established to address director and shareholder conflicts.

The issues addressed include:

- At least half of the members of the board should be independent, **non-executive directors** (excluding the chair)
- The role of the **chair and chief executive officer** should be **separate**
- **Remuneration** of the **chair** and **highest paid director** should be disclosed
- **Executive directors** should submit themselves for **re-election** every three years
- There should be **independent remuneration and nomination committees**
- Shareholders should be able to **vote** separately on each **substantially separate issue**

Stock exchange listing requirements for corporate governance:

- listed companies **must** disclose how they have **applied the principles** and **complied with the code**, and
- state and explain any **deviation** from the **recommended practice**, and
- disclose full details of **directors' remuneration** packages, which should be submitted to **shareholders** for **approval.**

Do you understand?

1 Customers are an internal stakeholder of an organisation.

True or False

2 The agency problem is a driving force behind the growing importance attached to sound corporate governance. In this case the managers are the agents.

Yes or No

1 False. Customers are connected stakeholders of an organisation.

2 Yes. The managers act as agents for the shareholders.

1.4 OBJECTIVES IN NOT FOR PROFIT ORGANISATIONS

LEARNING SUMMARY

After studying this section you should be able to:

- discuss the impact of not for profit status on financial and other objectives
- discuss the nature and importance of value for money as an objective in not for profit organisations
- discuss ways of measuring the achievement of objectives in not for profit organisations

KEY POINT The primary objective of not for profit organisations is not to make money but to benefit prescribed groups of people

Not for profit organisations include charities, public services, local government, trade unions, sports associations and professional institutes.

Objectives of not for profit organisations

Not for profit organisations will use a mixture of financial and non-financial objectives. What those objectives are will depend on:

- in whose interests is the organisation run?
- what are the objectives of the interested parties?

Financial objectives – a not for profit organisation will often have limited funds and therefore set financial targets.

Examples include:

- Total amount to be **raised**
- Amount to be spent on **fund raising**
- Spending on **specified projects** and **administration**
- **Budgetary control**
- **Breakeven**

Many key non- financial objectives are difficult to quantitfy and therefore most public bodies operate under objectives determined by the government.

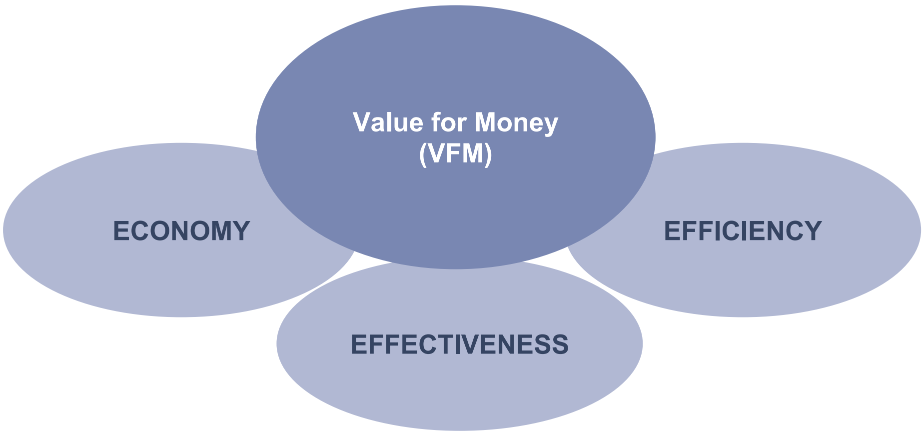
Value for money (VFM)

DEFINITION **Value for money –** achieving the desired level and quality of service at the most economical cost

Many not for profit organisations are funded by the public purse and the lack of clear financial performance measures can be seen as a problem.

Asessing whether an organisation provides value for money involves looking at all functioning aspects of the not for profit organisation, the three E's:

Use of the three E's as a performance measure and a way to assess VFM, is a key issue for exam questions relating to not for profit and public sector organisations



- **economy** – minimising the costs of inputs required to achieve a defined level of output, for example materials and staff
- **efficiency** – achieving a high level of output in relation to the resources put in (input driven) or providing a particular level of service at a reasonable input cost (output driven)
- **effectiveness** – whether outputs are achieved that match the predetermined objectives, i.e. the targets

Do you understand?

1 In the context of managing performance in not for profit organisations, which of the following is correct:

A Economy means doing things cheaply, not spending £2 when the same item can be bought for £1

B Efficiency means doing things quickly, minimising the amount of time spent on a given activity

1 A. Economy means not spending £2 when the same item can be bought for £1.

Exam style questions

1 **In relation to the financial management of a company, which of the following provides the best definition of a firm's primary financial objective?**

A To achieve long-term growth in earnings

B To maximise the level of annual dividends

C To maximise the wealth of its ordinary shareholder

D To maximise the level of annual profits

2 **Indicate whether the following objectives are financial or non-financial objectives of a company.**

Objective	Financial	Non-financial
Maximisation of market share		
Earnings growth		
Sales revenue growth		
Achieving a target level of customer satisfaction		
Achieving a target level of return on capital employed		

3 **Indicate whether the following statements are true or false.**

Statement	True	False
Financial management is concerned with the long-term raising of finance and the allocation and control of resources.		
Management accounting is concerned with providing information for the more day-to-day functions of control and decision making.		
Financial accounting is concerned with providing information about the historical results of past plans and decisions		

4 **What is the main purpose of corporate governance?**

A To separate ownership and management control of organisations

B To maximise shareholder value

C To facilitate effective management of organisations and to make organisations more visibly accountable to a wider range of stakeholders

D To ensure that regulatory frameworks are adhered to

5 Managerial reward schemes should help ensure managers take decisions which are consistent with the objectives of shareholders.

Which THREE of the following are characteristics of a carefully designed remuneration package?

A Linking of rewards to changes in shareholder wealth

B Matching of managers' time horizons to shareholders' time horizons

C Possibility of manipulation by managers

D Encouragement for managers to adopt the same attitudes to risk as shareholders