FINANCIAL MANAGEMENT FUNCTION

Financial management can be defined as the management of the finances of an organisation in order to achieve the financial objectives of the organisation. The usual assumption in financial management for the private sector is that the objective of the company is to **maximize shareholders' wealth**.

Financial Management Decisions

Decisions must be taken in three key areas:

The financial manager makes decisions relating to investment, financing and dividends. The management of risk must also be considered.

The investment decision

To operate, all businesses will need finance and part of the financial manager's role is to ensure this finance is used efficiently and effectively to ensure the organization's objectives are achieved.

The financing decision

Before a business can invest in anything, it needs to have some finance. A key financial management decision is the identification of the most appropriate sources (be it long- or short-term), taking into account the requirements of the company, the likely demands of the investors and the amounts likely to be made available.

The dividend decision

The decision on the level of dividends to be paid can affect the value of the business as a whole as well the ability of the business to raise further finance in the future having invested wisely, a business will hopefully be profitable and generate cash. The final key decision for the financial manager is whether to return any of that cash to the owners of the business (in the form of dividends) and if so, how much should be distributed.

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The difference between Financial Management, Financial Accounting and Management Accounting

Financial management is concerned with the long-term raising of finance and the allocation and control of resources; it involves targets, or objectives, that are generally long-term by nature, whilst management accounting usually operates within a 12-month time horizon.

Management accounting is concerned with providing information for the more day-to-day functions of control and decision-making. This will involve budgeting, cost accounting, variance analysis, and evaluation of alternative uses of short-term resources.

Financial accounting is not directly involved in the day-to-day planning, control and decision making of an organisation. Rather, it is concerned with providing information about the historical results of past plans and decisions. Its purpose is to keep the owners (shareholders) and other interested parties informed of the overall financial position of the business, and it will not be concerned with the detailed information used internally by management accountants and financial managers.

Corporate objectives

Corporate objectives are relevant for the organisation as a whole, relating to key factors for business success. Corporate objectives are those which are concerned with the firm as a whole. Objectives should be explicit, quantifiable and capable of being achieved. The corporate objectives outline the expectations of the firm and the strategic planning process is concerned with the means of achieving the objectives.

Objectives should relate to the **key factors for business success**, which are typically as follows.

- Profitability (return on investment)
- Market share
- Growth
- Cash flow
- Customer satisfaction
- The quality of the firm's products
- Industrial relations
- Added value

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Financial objectives

Financial targets may include targets for: earnings; earnings per share; dividend per share; gearing level; profit retention; operating profitability.

The usual assumption in financial management for the private sector is that the primary financial objective of the company is to maximize shareholders' wealth.

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Shareholder wealth maximisation

Shareholder wealth maximisation is a fundamental principle of financial management. You should seek to understand the different aspects of the syllabus (e.g. finance, dividend policy, investment appraisal) within this unifying theme.

The wealth of the shareholders in a company comes from:

- **Dividends** received
- **Market value** of the shares

If a company's shares are traded on a stock market, the wealth of shareholders is increased when the share price goes up. The price of a company's shares will go up when the company makes attractive profits, which it pays out as **dividends** or **reinvests** in the business to achieve future profit growth and dividend growth.

Many other objectives are also suggested for companies including:

- profit maximisation
- growth
- market share
- social responsibilities

Profit maximisation

In much economic theory, it is assumed that the firm behaves in such a way as to maximize profits the economist's assumption of profit maximisation would seem to be very reasonable. Remember though that the economist's concept of profits is broadly in terms of **cash**, whereas accounting profits may not equate to cash flows.

Earnings per share (EPS) growth

Earnings per share (EPS) is widely used as a measure of a company's performance and is of particular importance in comparing results over a period of several years. A company must be able to sustain its earnings in order to pay dividends and reinvest in the business so as to achieve future growth. Investors also look for growth in the EPS from one year to the next.

Note that:

- EPS is a figure based on past data
- It is easily manipulated by changes in accounting policies and by mergers or acquisitions.
- It does not represent income of the shareholder. Rather, it represents that investor's share of the income generated by the company according to an accounting formula.

Non-financial objectives

A company may have important **non-financial objectives** which must be satisfied in order to ensure the continuing participation of all stakeholders. Without their participation, financial objectives such as maximising shareholder wealth may be compromised in the future.

- The welfare of employees
- The welfare of management
- The provision of a service
- The fulfillment of responsibilities towards customers
- The fulfillment of responsibilities towards supplier
- The welfare of society as a whole

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Stakeholders

Stakeholders are individuals or groups who are affected by the activities of the firm. There are a variety of different groups or individuals whose interests are directly affected by the activities of a firm. These groups or individuals are referred to as stakeholders in the firms.

Stakeholder groups:

Internal	Employees and pensioners
	Managers
	Directors
Connected	Shareholders
	Debt holders (bondholders)
	Customers
	Bankers
	Suppliers
	Competitors
External	Government
	Pressure groups
	Local and national communities
	Professional and regulatory bodies

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Objectives of stakeholder groups

The various groups of stakeholders in a firm will have different goals which will depend in part on the particular situation of the enterprise. Some of the more important aspects of these different goals are as follows.

(a) **Ordinary (equity) shareholders**

Ordinary (equity) shareholders are the providers of the risk capital of a company. Usually their goal will be to maximize the wealth which they have as a result of the ownership of the shares in the company.

(b) **Trade payables (creditors**)

Trade payables have supplied goods or services to the firm. Trade payables will generally be profit-maximising firms themselves and have the objective of being paid the full amount due by the date agreed. On the other hand, they usually wish to ensure that they continue their trading relationship with the firm and may sometimes be prepared to accept later payment to avoid jeopardizing that relationship.

(c) **Long-term payables (creditors)**

Long-term payables, which will often be banks, have the objective of receiving payments of interest and capital on the loan by the due date for the repayments. Where the loan is secured on assets of the company, the lender will be able to appoint a receiver to dispose of the company's assets if the company defaults on the repayments. To avoid the possibility that this may result in a loss to the lender if the assets are not sufficient to cover the loan, the lender will wish to minimize the risk of default and will not wish to lend more than is prudent.

(d) **Employees**

Employees will usually want to maximize their rewards paid to them in salaries and benefits, according to the particular skills and the rewards available in alternative employment. Most employees will also want continuity of employment.

(e) **Government**

Government has objectives which can be formulated in political terms. Government agencies impinge on the firm's activities in different ways including through taxation of the firm's profits, the provision of grants, health and safety legislation, training initiatives, and so on. Government policies will often be related to macroeconomic objectives, such as sustained economic growth and high levels of employment.

(f) **Management**

Management has, like other employees (and managers who are not directors will normally be employees), the objective of maximising its own rewards. Directors, and the managers to whom

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they delegate responsibilities, must manage the company for the benefit of shareholders. The objective of reward maximisation might conflict with the exercise of this duty.

Shareholders and management

The **day to day** running of a company is the responsibility of **management.** Although the company's results are submitted for shareholders' approval at the annual general meeting (AGM)

Shareholders are often ignorant about their company's current situation and future prospects. They have no right to inspect the books of account, and their forecasts of future prospects are gleaned from the annual report and accounts, stockbrokers, investment journals and daily newspapers.

The relationship between management and shareholders is sometimes referred to as an **Agency Relationship**

Agency Relationships occur when one party, **the principal,** employs another party, **the agent,** to perform a task on their behalf. In particular, directors (agents) act on behalf of shareholders (principals).

Agency relationship: a description of the relationship between management and shareholders expressing the idea that managers act as agents for the shareholder, using delegated powers to run the company in the shareholders' best interests.

Problems of Agency Relationship

The agency relationship arising from the separation of ownership from management is sometimes characterized as the **'agency problem'**. The problem lies in the fact that once the agent has been appointed they are able to act in their own selfish interests rather than pursuing the objectives of the principal. It is argued that management will only make **optimal** decisions if they are monitored and appropriate incentives are given.

Agency Conflicts

- Moral Hazard
- Effort level
- Earning Retention
- Risk aversion
- Time horizon

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Managerial reward schemes

Goal congruence is accordance between the objectives of agents acting within an organisation and the objectives of the organisation as a whole.

Goal congruence may be better achieved and the 'agency problem' better dealt with by offering organizational rewards (more pay and promotion) for the achievement of certain levels of performance. The conventional theory of reward structures is that if the organisation establishes procedures for formal measurement of performance, and rewards individuals for good performance, individuals will be more likely to direct their efforts towards achieving the organization's goals.

One way to help ensure that managers take decisions which are consistent with the objectives of shareholders is to introduce carefully designed remuneration packages. The schemes should:

- be clearly defined, impossible to manipulate and easy to monitor
- link rewards to changes in shareholder wealth
- match managers' time horizons to shareholders' time horizons
- Encourage managers to adopt the same attitudes to risk as shareholders.

Common types of reward schemes include:

- Remuneration linked to:

– Minimum profit levels

– Economic value added (EVA)

– Revenue growth

– Executive share option schemes (ESOP).

Examples of such remuneration incentives are:

(a) **Performance-related pay**

Pay or bonuses are usually related to the size of profits, but other performance indicators may be used.

(b) **Rewarding managers with shares**

This might be done when a private company 'goes public' and managers are invited to subscribe for shares in the company at an attractive offer price. In a **management buy-out** or buy-in (the latter involving purchase of the business by new managers; the former by existing managers), managers become owner-managers.

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(c) **Executive share option plans (ESOPs)**

In a share option scheme, selected employees are given a number of share options, each of which gives the holder the right after a certain date to subscribe for shares in the company at a fixed price. The value of an option will increase if the company is successful and its share price goes up.

Benefits of Reward Schemes:

- Performance-related pay may give individuals an incentive to achieve a good performance level.
- Effective schemes also succeed in attracting and keeping the employees that are valuable to the organisation.
- By rewarding performance, an effective scheme creates an organisation focused on continuous improvement.
- Schemes based on shares can motivate employees/managers to act in the long-term interests of the organisation by doing things to increase the organization's market value.

Problems associated with reward schemes

- Self-interested performance may be encouraged at the expense of teamwork
- In order to make bonuses more accessible, standards and targets may have to be lowered, with knock-on effects on quality.
- A serious problem that can arise is that performance-related pay and performance evaluation systems can encourage dysfunctional behavior

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Measuring achievement of corporate objectives

Ways of measuring the progress of the enterprise, so that managers know how well the company is doing. A common means of doing this is through ratio analysis, which is concerned with comparing and quantifying relationships between financial variables, such as those variables found in the statement of financial position and statement of profit or loss of the enterprise.

Ratio analysis compares and quantifies relationships between financial variables.

Ratio analysis can be grouped into four main categories:

- Profitability and return
- Debt and gearing
- Liquidity
- Investor

➢ **Profitability**

A company ought of course to be profitable if it is to maximize shareholder wealth, and obvious checks on profitability are:

(a) Whether the company has made a profit or a loss on its ordinary activities

(b) By how much this year's profit or loss is bigger or smaller than last year's profit or loss

The most important profitability ratio is therefore return on capital employed (ROCE),

Ratios

1. $ROCE = \frac{PBIT}{\text{Capital Employed}}$

Capital Employed= total assets – Current liabilities

ROCE = Profit Margin x Assets Turnover

Profit Margin = $\frac{PBIT}{\text{Sales Revenue}}$

Asset Turnover = $\frac{\text{Sales Revenue}}{\text{Capital Employed}}$

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2. ROE = $\frac{\text{Earning attributable to ordinary Shareholders}}{\text{Shareholder's Equity}}$

- **Debt and gearing ratios**

Financial gearing (often simply referred to as 'gearing') is the amount of debt finance a company uses relative to its equity finance.

Debt ratios are concerned with how much the company owes in relation to its size and whether it is getting into heavier debt or improving its situation.

Financial Gearing

(A) $\frac{\text{Debt Capital}}{\text{Equity Capital}}$

(B) $\frac{\text{Debt Capital}}{\text{Equity Capital + Debt Capital}}$

Operational Gearing

(A) $\frac{\text{Fixed Costs}}{\text{Variable Costs}}$

(B) $\frac{\text{\% Change in EBIT}}{\text{\% Change in sales revenue}}$

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- **Liquidity ratios: cash and working capital**

It tells us whether a company's current assets are enough to cover their liabilities. Although it's always a good idea for business owners to have a robust understanding of their company's liquidity

Current Ratio

$$\frac{\text{Current Assets}}{\text{Current liabilities}}$$

Quick Ratio

$$\frac{\text{Current Assets – inventory}}{\text{Current Liabilities}}$$

- **Shareholders' investment ratios**

A company will only be able to raise finance if investors think that the returns they can expect are satisfactory in view of the risks they are taking. We must therefore consider how investors appraise companies. We will concentrate on quoted companies.

Cum dividend or **cum div** means the purchaser of shares is entitled to receive the next dividend payment.

Ex-dividend or **ex div** means that the purchaser of shares is not entitled to receive the next dividend payment.

Dividend Yield: $$\frac{\text{Dividend per Share}}{\text{Market price per share}}$$

Earning per Share: $$\frac{\text{Profit distributable to ordinary shareholders}}{\text{Number of Ordinary shares issue}}$$

Price / Earning Ratio: $$\frac{\text{Current Market Price per share}}{\text{Earning per share}}$$

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Corporate governance

Corporate governance is the system by which organizations are directed and controlled. Good corporate governance involves ensuring the effectiveness of risk management and internal control, accountability to shareholders and other stakeholders, and conducting business in an ethical and effective way.

Key elements in corporate governance

a) The management and reduction of risk is a fundamental issue in all definitions of good governance, whether explicitly stated or merely implied.

b) The notion that overall performance is enhanced by good organizational structures and management practice within set best practice guidelines underpins most definitions.

c) Good governance provides a framework for an organisation to pursue its strategy in an ethical and effective way from the perspective of all stakeholder groups affected, and offers safeguards against misuse of resources, physical or intellectual.

d) Good governance is not just about externally established codes but also requires a willingness to apply the spirit as well as the letter of the law.

e) Accountability is generally a major theme in all governance frameworks.

Non-executive directors (NEDs)

– Important presence on the board

– Must give obligation to spend sufficient time with the company

– Should be independent.

– At least half the board to be independent NEDs

Executive directors

– Separation of chairman and chief executive officer (CEO)

– Submit for re-election

– Clear disclosure of financial rewards

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Objectives in Not-for-profit Organizations

The primary objective of not-for-profit organisation (NFPs or NPOs) is not to make money but to benefit prescribed groups of people.

Here are some possible objectives for a NFP organisation.

- Surplus maximisation (equivalent to profit maximisation e.g. a charity shop)
- Revenue maximisation (as for a commercial business e.g. a charity shop)
- Usage maximisation (for example, leisure center swimming pool usage)
- Usage targeting (matching the capacity available, for example, in a government-funded hospital)
- Full/partial cost recovery (minimizing subsidy)
- Budget maximisation (maximising what is offered)
- Producer satisfaction maximisation (satisfying the wants of staff and volunteers)
- Client satisfaction maximisation (the police generating the support of the public)

Value for money

Value for money can be defined as getting the best possible combination of services from the least resources, which means maximising the benefits for the lowest possible cost.

This is usually accepted as requiring the application of economy, effectiveness and efficiency (sometimes known as the 3Es).

Economy: Minimizing the costs of inputs required to achieve a defined level of output.

Efficiency: Ratio of outputs to inputs – achieving a high level of output in relation to the resources put in (input driven) or providing a particular level of service at reasonable input cost (output driven)

Effectiveness: Whether outputs are achieved that match the predetermined objectives.

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FINANCIAL MANAGEMENT ENVIRONMENT

Macroeconomic policy is the management of the economy by government in such a way as to influence the performance and behavior of the economy as a whole.

The principal objectives of macroeconomic policy will be to achieve the following:

- **Full employment of resources:** The full employment of resources applies in particular to the labour force. The aim is both full and stable employment.

- **Price stability (low inflation):** Price stability means little or no inflation putting upward pressure on prices.

- **Economic growth:** Economic growth is measured by changes in national income from one year to the next and is important for improving living standards.

- **Balance of payments equilibrium:** The balance of payments relates to the ratio of imports to exports. A payment surplus would mean the value of exports exceeds that of imports. A payment deficit would occur where imports exceed exports.

- **An appropriate distribution of income and wealth:** What is considered an appropriate distribution of income and wealth will depend upon the prevailing political view at the time.

Policies for achieving macroeconomics targets

Monetary policy

Monetary policy aims to influence monetary variables

- The rate of inflation
- Interest rates
- Money supply

Monetary policy can also affect the value of a country's currency. In general terms:

- Higher interest rates are likely to attract more investors into buying investments in the currency, and
- Lower interest is likely to persuade investors to sell their investments in the currency.

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Monetary policy and business

Businesses might be affected by the monetary policies of the government in a variety of ways.

- In the long term, businesses benefit from government control over the rate of inflation and restricted rises in prices, because real economic growth is likely to be greater.

- Changes in interest rates affect the cost of borrowing, and so profits. Higher interest rates on long-term finance might deter companies from making some new investments, which will result in a reduction in their capital spending.

- Changes in interest rates might affect spending by customers. For example, higher interest rates might reduce consumer spending, and so make it more difficult for companies to sell their goods and services.

- Changes in the exchange rate affect companies that sell goods to other countries or buy from suppliers in other countries.

Fiscal policy

Fiscal policy involves using government spending and taxation in order to influence aggregate demand in the economy.

- Taxation
- Borrowing

Fiscal policy and business

Fiscal policy affects business in a variety of ways.

- Companies might try to minimize their tax liabilities, possibly by transferring business operations to low-tax countries.

- The investment decisions by companies could be affected by tax. For example, the government might offer some tax relief for new investments, and companies will expect to receive tax allowances for capital investment.

- Spending decisions by customers could be affected by the rate of sales tax or value added tax. If the government increases the rate of value added tax, the volume of customer demand for the goods and services of companies will probably fall.

- Other tax changes can affect the rate of growth in the economy. For example, an increase in rates of income tax on individuals will reduce their spending ability.

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Exchange rate policy

Economic objectives can be achieved through management of the exchange rate by the government. The strength or weakness of sterling's value, for example, will influence the volume of UK imports and exports, the balance of payments and interest rates.

External trade policy

A government might have a policy for promoting economic growth by stimulating exports

Competition policy

The government influences markets in various ways, one of which is through direct regulation (e.g. the Competition and Markets Authority)

Privatisation

Privatisation is a policy of introducing private enterprise into industries which were previously state-owned or state-operated.

Advantages of Privatisation.

(a) It provides an immediate source of money for the government.

(b) It reduces bureaucratic and political meddling in the industries concerned.

(c) It encourages wider share ownership.

Financial intermediaries

A financial intermediary is an institution bringing together providers and users of finance, either as broker or as principal.

Financial intermediaries also provide a **ready source of funds** for **borrowers**. Even when money is in short supply, a borrower will usually find a financial intermediary prepared to lend some.

(c) They can **aggregate** smaller savings deposited by savers and lend on to borrowers in larger amounts.

(d) **Risk** for individual lenders is reduced by **pooling**

(e) By pooling the funds of large numbers of people, some financial institutions are able to give investors access to **diversified portfolios** covering a varied range of different securities

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FINANCIAL MARKETS

Financial markets are the markets where individuals and organisations with surplus funds lend funds to other individuals and organisations that want to borrow.

Financial Markets can be classified as

- **Capital markets:** are markets for medium-term and long-term capital
- **Money markets:** are markets for short-term capital

The financial markets serve two main purposes:

(a) Primary Markets: they enable organisations to **raise new finance**, by issuing new shares or new bonds

(b) Secondary Markets: they enable existing investors to buy and sell existing investments, should they wish to do so

Capital markets are financial markets for primary issues and secondary market trading in long-term investments: equities and bonds. The capital markets are both national ('domestic') and international.

The capital markets can be classified into:

- Stocks markets
- Bond markets

Stock Market

A stock market is a market place for buying and selling shares in companies that apply to have their shares traded on the exchange and whose application is accepted.

The main functions of a stock exchange are to:

- Provide a system in which shares can be traded in a regulated manner
- Enforce rules of business conduct on market participants, to ensure fair dealing
- Ensure that there is an efficient system for providing new financial information about companies to investors in the market
- Provide a system for recording information about the prices at which shares are bought and sold, and providing share price information to participants in the market.

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The bond markets

There are also domestic bond markets. Bonds are debt instruments issued by governments, government agencies, international organisations and companies. The bond markets are not accessible to small companies.

The money markets

Money markets are for trading in financial instruments with a much shorter maturity. As a general guide, the maturity of instruments in the money markets is not usually longer than one year, but the maturity of many transactions and instruments is less than three months, even 'overnight'.

Examples of money market transactions and instruments are as follows:

- The interbank market
- Treasury bills
- Certificates of Deposit (CDs)
- The repo market.

The Treasury Function

The treasury function of a firm usually has the following roles:

Short-term management of resources

- Short-term cash management – lending/borrowing funds as required.
- Currency management.

Long-term maximisation of shareholder wealth

- Raising long-term finance, including equity strategy, management of debt capacity and debt and equity structure.
- Investment decisions, including investment appraisal, the review of acquisitions and divestments and defence from takeover.
- Dividend policy.

Risk management

- Assessing risk exposure.
- Interest rate risk management.
- Hedging of foreign exchange risk

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The case for centralizing treasury management

A company must choose between having its treasury management:

- Centralized
- Decentralized

If they are centralised, each operating company holds only the minimum cash balance required for day-to-day operations, remitting the surplus to the Centre for overall management. This process is sometimes known as cash pooling; the pool usually being held in a major financial Centre or a tax haven country.

If they are decentralised, each operating company must appoint an officer responsible for that company's own treasury operations.

Advantages of centralization

- No need for treasury skills to be duplicated throughout the group
- Necessary borrowings can be arranged in bulk
- The group's foreign currency risk can be managed much more effectively
- One company does not borrow at high rates while another has idle cash.

Advantages of decentralization

- Greater autonomy leads to greater motivation
- Local operating units should have a better feel for local conditions than head office and can respond more quickly to local developments.

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Sum up: Financial Market

Bear in mind that **financial markets** and **institutions** are topic areas which the ACCA examining team are likely to test in Section A of the exam.

A **financial intermediary** links those with surplus funds (eg **lenders**) to those with fund deficits (eg potential **borrowers**) thus providing **aggregation** and **economies of scale**, **risk pooling** and **maturity transformation**.

A **financial intermediary** is an institution bringing together providers and users of finance, either as broker or as principal.

A **financial intermediary** links lenders with borrowers, by obtaining deposits from lenders and then re-lending them to borrowers.

Financial markets are the markets where individuals and organisations with surplus funds lend funds to other individuals and organisations that want to borrow.

Capital markets are markets for medium-term and long-term capital.

Money markets are markets for short-term capital.

The **money market** refers to trading in very short-term debt investments.

At the wholesale level, it involves large-volume trades between institutions and traders.

At the retail level, it includes **money market** mutual **funds** bought by individual investors and **money market** accounts opened by bank customers.

Commercial paper - short-term unsecured promissory notes issued by companies

Commercial paper is a commonly used type of unsecured, short-**term** debt instrument issued by corporations, typically used for the financing of payroll, accounts payable and inventories, and meeting other short-**term** liabilities.

Treasury Bill (T-**Bill**) are government bonds or debt **securities** with maturity of less than a year (Short Dated).

T- **bills** are issued to meet short-term mismatches in receipts and expenditure.

Types of Treasury Bills - Examples

1. 14-day **Treasury bill**. These **bills** complete their maturity on 14 days from the date of issue. ...
2. 91-day **Treasury bill**. These **bills** complete their maturity on 91 days from the date of issue. ...

Bonds of longer maturity are called dated **securities**.

CD

a certificate issued by a bank to a person depositing money for a specified length of time at a specified rate of interest.

Basis risk is the risk that the futures price might not move in normal, steady correlation with the price of the underlying **asset**.

Correctly identifying and, and that this fluctuation in the basis may negate the effectiveness of a hedging strategy employed to minimize a trader's exposure to potential loss.

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