CHAPTER 1:
INTRODUCTION TO FINANCIAL MANAGEMENT

1. WHAT IS FINANCIAL MANAGEMENT?

- Financial Management (FM) can be defined as the "the planning and control of finance so as to achieve the **financial objectives** of a business".

- The **primary objective** of limited companies is to ***maximise shareholders wealth***. This could be achieved by capital appreciation (increase in share price) and/or dividend payout.

- In practice it is difficult to **maximise shareholder wealth** (seeking the best possible outcome) because of conflicting interests arising from the wishes of other stakeholders **(secondary objectives)**. E.g. Directors want higher remuneration but this will reduce the profits available for payments of dividends to shareholders.

- Therefore a **satsficing** (merely adequate) return rather than a maximisation of shareholder return is achieved.

- In order to **maximise shareholders wealth the directors** (the board) must make the following four major decisions:

  (i) Investment decisions – should proposed investments (including acquisitions be undertaken?)

  (ii) Financing decisions – From what sources should funds be raised to finance proposed investments? (debt vs equity)

  (iii) Dividend decisions - how much and how frequently should cash be paid out to shareholders)

  (iv) Risk Management decisions – involves the identification of risks, followed by a decision as to whether to obtain some cover and if so, what form of cover.

Link between Financial Management and Financial Reporting

Pat Co SOFP

ASSETS			
PPE		X	**capital investment decisions**. Use NPV,
Investments		X	IRR, payback, ARR
Current assets – inventory	working	X –	EOQ, JIT, re-order level, bulk discounts
- receivables	capital	X –	factoring, settlement discounts
- cash	mgt	X –	cash budgets, Miller Orr & Baumol models
		X	
Risk Mgt			
		=====	
and			
EQUITY			
Business			
Share capital & reserves		X	- Ke (CAPM & DVM)
Valuations			
DEBT			**financing decisions**. Debt Vs Equity
Non-current – bonds or bank loan: Kd(i-t)		X	'cost of capital'
Current – overdrafts, payables		X	
		X	
		=====	

Pat Co SOCI for the year ended xx/xx/xxxx

Profit for the year	X	**dividend decisions**. How much to payout?

Note: Pat co as a business needs to be valued, hence **business valuations** (can use P/E, DVM, cash flow or asset based valuation) in additional the investment and financing decisions will have risk attached (e.g. Foreign currency, interest rate risk..) hence **risk management** is vital.

2. OTHER STAKEHOLDERS AND THEIR OBJECTIVES

STAKEHOLDER GROUP	OBJECTIVES
Directors & Managers	Attractive remuneration packages, greater control, Empire building (prestige)
Lenders	Receipt of interest, repayment of principal at maturity, low risk
Employees	High salaries/wages, security of employment
Suppliers	Repayment of owed amount, continuous of business
Customers	low prices, to obtain highest quality products and after sales services
Wider community	share in the wealth created (perhaps schools, better housing, prevention of environmental damage
Government	job creation, safety for potential employees, tax through tax authorities

The stakeholders can be grouped as Internal (e.g. employees), External (e.g. government, community) and connected (e.g. shareholders, suppliers, customers, lenders)

3. CONFLICT OF INTEREST – SHAREHOLDERS AND DIRECTORS

Common conflicts, which occur between directors and shareholders, are:

- **Performance -** if directors are judged on profit performance they may take actions to increase short term profits at the expense of longer term benefits to shareholders.

- **Attitude to diversification** – shareholders can spread their risk by investing in a number of different companies. Directors cannot do this

- **Takeovers** – directors may spend substantial amounts of time and money defending their company against a takeover which would be beneficial to shareholders.

- **Gearing (levels of debt)** – as managers are likely to be more cautious over risk than shareholders they wish to adopt lower levels of financial gearing than would be undertaken by the shareholders or the directors may want to use debt against the wishes of the shareholders.

  The term ***'agency relationship'*** describes the relationship, which exists between a principal and a person hired by the principal to act on his behalf.

  Shareholders appoint directors to run the company on their behalf. The relationship between shareholders and directors may clearly be described as that of agency.

  Agency problem arises when directors take decisions that DO NOT lead to the maximization of shareholder wealth.

How can shareholders avoid or reduce conflict of interest with directors?

a) They may incur costs to control the activities of managers e.g. by instituting a process of ***management audit***.

b) They may rely on the idea of '***goal congruence***' i.e. convincing directors that activities directed towards maximising company profits would at the same time benefit themselves. Shareholders may do this by offering directors:

   - Share option schemes (to be offered shares at a given future date based on a fixed price – usually today's price). Note, however that share option schemes will only be of value if the share price will increase in future.

   - Profit-related salaries and bonuses based on performance

c) Corporate governance provisions (e.g. UK Combined Code: - having NED on remuneration and audit committees) – covered in AA and SBL

d) Finally directors must always be aware of the threat of dismissal if their performance is unsatisfactory.

Real life Example of Agency Problem: The Fall of Enron

The collapse of energy giant Enron in 2001 showed how catastrophic the **agency problem** can be. The company's officers and board of directors, including Chairman Kenneth Lay, CEO Jeffrey Skilling and CFO Andy Fastow, were selling their Enron stock at higher prices due to false accounting reports that made the stock seem more valuable than it truly was. After the scandal was uncovered, thousands of stockholders lost millions of dollars as Enron share values plummeted.

4. OBJECTIVES OF NON-PROFIT ORGANISATIONS (NFP)

- NFP organizations include: government funded functions (public sector), charities, trade unions. The equivalent of shareholder wealth is value for money.

- With no shareholders it is important to determine:

  (i) Who are the stakeholders?
  (ii) What are their objectives?

- Value for money (VFM) means providing a service in a way which is economical, efficient and effective (3 E's)

Economy – is concerned with the cost of inputs by obtaining those inputs at the lowest acceptable cost but not compromising on quality.

Efficiency – means doing things well i.e. achieving maximum output from a given input or using minimum input for a required output. (ratio of input to output)

Effectiveness – is the extent to which a programme achieves its established objectives.

- Example, in a public school, measures could be:

Economy: **-** cost of teachers
- cost of administration

Efficiency: - cost/pupil
- number of pupils/teacher

Effectiveness: - pass rates
- number of pupils moving to university/college.

RELEVANT ACCA ARTICLE TO READ – 'Myopic Management'

