PART A

Financial management function

1 Financial management and financial objectives

Topic list	Syllabus reference
1 The nature and purpose of financial management	A1(a), (b)
2 Financial objectives and the relationship with corporate strategy	A2 (a), (b)
3 Stakeholders	A3 (a), (b), (c)
4 Measuring the achievement of corporate objectives	A3 (d)
5 Encouraging the achievement of stakeholder objectives	A3 (e)
6 Not-for-profit organisations	A4 (a), (b), (c)

Introduction

In Parts A and B of this study text we examine the work of the financial management function and the framework within which it operates.

In this chapter, after introducing the **nature and purpose of financial management**, we consider the **objectives** of organisations. We go on to examine the influence of **stakeholders** on stakeholder objectives.

The final part of this chapter examines objectives in **not-for-profit** organisations.

Study guide

		Intellectual level
A	**Financial management function**	
1	**The nature and purpose of financial management**	
(a)	Explain the nature and purpose of financial management.	1
(b)	Explain the relationship between financial management and financial and management accounting.	1
2	**Financial objectives and the relationship with corporate strategy**	
(a)	Discuss the relationship between financial objectives, corporate objectives and corporate strategy.	2
(b)	Identify and describe a variety of financial objectives, including:	2
(i)	shareholder wealth maximisation	
(ii)	profit maximisation	
(iii)	earnings per share growth	
3	**Stakeholders and impact on corporate objectives**	
(a)	Identify the range of stakeholders and their objectives	2
(b)	Discuss the possible conflict between stakeholder objectives	2
(c)	Discuss the role of management in meeting stakeholder objectives, including the application of agency theory.	2
(d)	Describe and apply ways of measuring achievement of corporate objectives including:	2
(i)	ratio analysis, using appropriate ratios such as return on capital employed, return on equity, earnings per share and dividend per share	
(ii)	changes in dividends and share prices as part of total shareholder return	
(e)	Explain ways to encourage the achievement of stakeholder objectives, including:	2
(i)	managerial reward schemes such as share options and performance-related pay	
(ii)	regulatory requirements such as corporate governance codes of best practice and stock exchange listing regulations	
4	**Financial and other objectives in not-for-profit organisations**	
(a)	Discuss the impact of not-for-profit status on financial and other objectives.	2
(b)	Discuss the nature and importance of Value for Money as an objective in not-for-profit organisations.	2
(c)	Discuss ways of measuring the achievement of objectives in not-for-profit organisations.	2

Exam guide

The material in this chapter is examinable as an entire discussion question or as a question involving calculations such as ratios and discussion. When doing a ratio analysis question, you must make sure you **apply** your answer to the organisation in the question. The organisation will not necessarily be a publicly quoted company with shareholders.

1 The nature and purpose of financial management

FAST FORWARD

Financial management decisions cover **investment** decisions, **financing** decisions, **dividend** decisions and **risk management**.

1.1 What is financial management?

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 **maximise shareholders' wealth.**

1.2 Financial planning

The financial manager will need to **plan** to ensure that enough funding is available at the right time to meet the needs of the organisation for short, medium and long-term capital.

(a) In the short term, funds may be needed to pay for purchases of inventory, or to smooth out changes in receivables, payables and cash: the financial manager is here ensuring that **working capital requirements** are met.

(b) In the medium or long term, the organisation may have planned purchases of **non-current assets** such as plant and equipment, for which the financial manager must ensure that **funding** is available.

The financial manager contributes to decisions on the uses of funds raised by **analysing financial data** to **determine uses** which meet the **organisation's financial objectives.** Is project A to be preferred to Project B? Should a new asset be bought or leased?

1.3 Financial control

The **control** function of the financial manager becomes relevant for funding which has been raised. Are the various activities of the organisation meeting its objectives? Are assets being used efficiently? To answer these questions, the financial manager may **compare data** on **actual performance** with **forecast performance**. Forecast data will have been prepared in the light of past performance (historical data) modified to reflect expected future changes. Future changes may include the effects of economic development, for example an economic recovery leading to a forecast upturn in revenues.

1.4 Financial management decisions

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

Investments in assets must be **financed** somehow. Financial management is also concerned with the **management of short-term funds** and with how funds can be raised over the long term.

The retention of profits is a financing decision. The other side of this decision is that if profits are retained, there is less to pay out to shareholders as dividends, which might deter investors. An appropriate balance needs to be struck in addressing the **dividend decision**: how much of its profits should the company pay out as dividends and how much should it retain for investment to provide for future growth and new investment opportunities?

We shall be looking at various aspects of the investment, financing and dividend decisions of financial management throughout this Study Text.

Examples of different types of investment decision	
Decisions **internal** to the business enterprise	• Whether to undertake new projects • Whether to invest in new plant and machinery • Research and development decisions • Investment in a marketing or advertising campaign
Decisions involving **external parties**	• Whether to carry out a takeover or a merger involving another business • Whether to engage in a joint venture with another enterprise
Disinvestment decisions	• Whether to sell off unprofitable segments of the business • Whether to sell old or surplus plant and machinery • The sale of subsidiary companies

Question

Disposal of surplus assets

'The financial manager should identify surplus assets and dispose of them'. Why?

Answer

A surplus asset earns no return for the business. The business is likely to be paying the 'cost of capital' in respect of the money tied up in the asset, ie the money which it can realise by selling it.

If surplus assets are sold, the business may be able to invest the cash released in more productive ways, or alternatively it may use the cash to cut its liabilities. Either way, it will enhance the return on capital employed for the business as a whole.

Although selling surplus assets yields short-term benefits, the business should not jeopardise its activities in the medium or long term by disposing of productive capacity until the likelihood of it being required in the future has been fully assessed.

1.5 Management accounting, financial accounting and financial management

Of course, it is not just people *within* an organisation who require information. Those **external** to the organisation such as banks, shareholders, HM Revenue and Customs, creditors and government agencies all desire information too.

Management accountants provide **internally used** information. The **financial accounting function** provides **externally used** information. The management accountant is not concerned with the calculation of earnings per share for the income statement and the financial accountant is not concerned with the variances between budgeted and actual labour expenditure.

Management information provides a **common source** from which are prepared financial accounts and management accounts. The **differences** between the two types of accounts arise in the manner in which the common source of data is **analysed**.

Financial accounts	Management accounts
Financial accounts **detail the performance of an organisation over a defined period and the state of affairs at the end of that period.**	Management accounts are **used to aid management to record, plan** and **control activities and to help the decision-making process.**
Limited companies must, **by law**, prepare financial accounts.	There is **no legal requirement** to prepare management accounts.

Financial accounts	Management accounts
The **format** of published financial accounts is determined by **law** and by **accounting standards**. In principle the accounts of different organisations can therefore be easily compared.	The **format** of management accounts is entirely at management discretion: **no strict rules** govern the way they are prepared or presented.
Financial accounts **concentrate on the business as a whole**, aggregating revenues and costs from different operations, and are an end in themselves.	Management accounts can **focus on specific areas** of an organisation's activities. Information may aid a decision rather than be an end product of a decision.
Most financial accounting information is of a **monetary** nature.	Management accounts incorporate **non-monetary** measures.
Financial accounts present an essentially **historic** picture of **past** operations.	Management accounts are both a **historical** record and a **future** planning tool.

As we have seen financial management is **the management of finance**. Finance is used by an organisation just as, for example, labour is used by an organisation. Finance therefore needs management in a similar way to labour. The management accounting function provides information to ensure the effective management of labour and, in the same way, the financial management function provides information on, for example, projected cash flows to aid the **effective** management of finance.

2 Financial objectives and the relationship with corporate strategy 6/09

FAST FORWARD

Strategy is a course of action to achieve an objective.

2.1 Strategy

Strategy may be defined as a course of action, including the specification of resources required, to achieve a specific objective.

Strategy can be **short-term** or **long-term**, depending on the time horizon of the objective it is intended to achieve.

This definition also indicates that since strategy depends on objectives or targets, the obvious starting point for a study of corporate strategy and financial strategy is the **identification and formulation of objectives**.

Key term

Financial strategy can be defined as 'the identification of the possible strategies capable of maximising an organisation's net present value, the allocation of scarce capital resources among the competing opportunities and the implementation and monitoring of the chosen strategy so as to achieve stated objectives'.

Financial strategy depends on stated **objectives** or **targets**. Examples of objectives relevant to financial strategy are given below.

Case Study

The following statements of objectives, both formally and informally presented, were taken from recent annual reports and accounts.

Tate & Lyle ('a global leader in carbohydrate processing')

The board of Tate & Lyle is totally committed to a strategy that will achieve a substantial improvement in profitability and return on capital and therefore in shareholder value. To that end we will:

- Continue to develop higher margin, higher-value-added and higher growth carbohydrate-based products, building on the Group's technology strengths in our world-wide starch business.
- Ensure that all retained assets produce acceptable returns.
- Divest businesses which do not contribute to value creation, and/or are no longer core to the Group's strategy.
- Conclude as rapidly as practicable our review of the strategic alternatives available to us in our US sugar operations.
- Continue to improve efficiency and reduce costs through our business improvement projects which include employee development and training programmes.

Kingfisher ('one of Europe's leading retailers concentrating on market serving the home and family')

Customers are our primary focus. We are determined to provide them with an unbeatable shopping experience built on great value, service and choice, whilst rapidly identifying and serving their ever-changing needs.

This goal is pursued through some of Europe's best known retail brands and increasingly through innovative e-commerce channels which harness our traditional retailing expertise.

By combining global scale and local marketing we aim to continue to grow our business, deliver superior returns to our shareholders and provide unique and satisfying opportunities for our people.

2.2 Corporate objectives

FAST FORWARD

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

2.3 Financial objectives

FAST FORWARD

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 **maximise shareholders' wealth.**

2.3.1 Shareholder wealth maximisation

12/08, 6/10

If the financial objective of a company is to maximise the value of the company, and in particular the value of its ordinary shares, we need to be able to put values on a company and its shares. How do we do it?

Three possible methods for the valuation of a company might occur to us.

(a) **Statement of financial position (balance sheet) valuation**

Here assets will be valued on a **going concern basis**. Certainly, investors will look at a company's statement of financial position. If retained profits rise every year, the company will be a profitable one. Statement of financial position values are not a measure of 'market value', although retained profits might give some indication of what the company could pay as dividends to shareholders.

(b) **Break-up basis**

This method of valuing a business is only of interest when the business is threatened with **liquidation**, or when its management is thinking about selling off individual assets to raise cash.

(c) **Market values**

The market value is the price at which buyers and sellers will trade stocks and shares in a company. This is the method of valuation which is most relevant to the financial objectives of a company.

(i) When shares are traded on a recognised stock market, such as the Stock Exchange, the market value of a company can be measured by the **price** at which shares are currently being traded.

(ii) When shares are in a private company, and are not traded on any stock market, there is no easy way to measure their market value. Even so, the financial objective of these companies should be to **maximise** the **wealth** of their **ordinary shareholders**.

The wealth of the shareholders in a company comes from:

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

A shareholder's **return** on investment is obtained in the form of:

- **Dividends** received
- **Capital gains** from increases in the market value of his or her 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 **re-invests** in the business to achieve future profit growth and dividend growth. However, to increase the share price the company should achieve its attractive profits without taking **business risks** and **financial risks** which worry shareholders.

If there is an increase in earnings and dividends, management can hope for an increase in the share price too, so that shareholders benefit from both **higher revenue** (dividends) and also **capital gains** (higher share prices). **Total shareholder return** is a measure which combines the increase in share price and dividends paid and can be calculated as:

$$(P_1 - P_0 + D_1)/P_0$$

Where P_0 is the share price at the beginning of the period

P_1 is the share price at the end of period

D_1 is the dividend paid

Management should set **targets** for factors which they can influence directly, such as **profits** and **dividend growth**. A financial objective might be expressed as the aim of increasing profits, earnings per share and dividend per share by, say, 10% a year for each of the next five years.

2.3.2 Profit maximisation

In much of economic theory, it is assumed that the firm behaves in such a way as to **maximise profits**, where profit is viewed in an economist's sense. Unlike the accountant's concept of cost, total costs by this economist's definition includes an element of reward for the risk-taking of the entrepreneur, called 'normal profit'.

Where the entrepreneur is in **full managerial control** of the firm, as in the case of a small owner-managed company or partnership, 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.

Even in companies owned by shareholders but run by non-shareholding managers, if the manager is serving the company's (ie the shareholders') interests, we might expect that the profit maximisation assumption should be close to the truth.

Although profits do matter, they are not the best measure of a company's achievements.

(a) Accounting profits are not the same as 'economic' profits. Accounting profits can be **manipulated** to some extent by choices of accounting policies.

Question — **Manipulation of profits**

Can you give three examples of how accounting profits might be manipulated?

Answer

Here are some examples you might have chosen.

(a) Provisions, such as provisions for depreciation or anticipated losses
(b) The capitalisation of various expenses, such as development costs
(c) Adding overhead costs to inventory valuations

(b) Profit does not take account of **risk**. Shareholders will be very interested in the level of risk, and maximising profits may be achieved by increasing risk to unacceptable levels.

(c) Profits on their own take no account of the **volume of investment** that it has taken to earn the profit. Profits must be related to the volume of investment to have any real meaning. Hence measures of financial achievement include:

(i) Accounting return on capital employed
(ii) Earnings per share
(iii) Yields on investment, eg dividend yield as a percentage of stock market value

(d) Profits are reported every year (with half-year interim results for quoted companies). They are measures of **short-term** performance, whereas a company's performance should ideally be judged over a longer term.

2.3.3 Earnings per share growth

Pilot Paper, 12/08, 6/09

Key term

> **Earnings per share** is calculated by dividing the net profit or loss attributable to ordinary shareholders by the weighted average number of ordinary shares.

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 re-invest in the business so as to achieve future growth. Investors also look for **growth** in the EPS from one year to the next.

Question — **Earnings per share**

Walter Wall Carpets made profits before tax in 20X8 of $9,320,000. Tax amounted to $2,800,000.

The company's share capital is as follows.

	$
Ordinary shares (10,000,000 shares of $1)	10,000,000
8% preference shares	2,000,000
	12,000,000

Calculate the EPS for 20X8.

Answer

	$
Profits before tax	9,320,000
Less tax	2,800,000
Profits after tax	6,520,000
Less preference dividend (8% of $2,000,000)	160,000
Earnings attributable to ordinary shareholders	6,360,000
Number of ordinary shares	10,000,000
EPS	63.6c

Question

Earnings per share growth

Grasshopper made earnings attributable to shareholders of $8,250,000 in 20X8 and $8,880,000 in 20X9. The company's share capital was 12 million ordinary shares of $1 each in both years.

Calculate the EPS for 20X8 and 20X9 and EPS growth in relative and absolute terms.

Answer

	$
Earnings attributable to ordinary shareholders (20X8)	8,250,000
Number of ordinary shares	12,000,000
EPS (20X8)	68.8c
Earnings attributable to ordinary shareholders (20X9)	8,880,000
Number of ordinary shares	12,000,000
EPS (20X9)	74.0c
EPS growth (absolute) (74.0 – 68.8)	5.2c
EPS growth (relative) (5.2/68.8)	7.6%

Note that:

(a) EPS is a figure based on **past data**, and
(b) It is **easily manipulated** by changes in accounting policies and by mergers or acquisitions

The use of the measure in calculating management bonuses makes it particularly liable to manipulation. The attention given to EPS as a performance measure by City analysts is arguably disproportionate to its true worth. Investors should be more concerned with future earnings, but of course estimates of these are more difficult to reach than the readily available figure.

2.3.4 Other financial targets

In addition to targets for earnings, EPS, and dividend per share, a company might set **other financial targets**, such as:

(a) A restriction on the company's level of **gearing**, or debt. For example, a company's management might decide:

  (i) The ratio of long-term debt capital to equity capital should never exceed, say, 1:1.

(ii) The cost of interest payments should never be higher than, say, 25% of total profits before interest and tax.

(b) A target for **profit retentions**. For example, management might set a target that dividend cover (the ratio of distributable profits to dividends actually distributed) should not be less than, say, 2.5 times.

(c) A target for **operating profitability**. For example, management might set a target for the profit/sales ratio (say, a minimum of 10%) or for a return on capital employed (say, a minimum ROCE of 20%).

These financial targets are not primary financial objectives, but they can act as subsidiary targets or constraints which should help a company to achieve its main financial objective without incurring excessive risks. They are usually measured over a year rather than over the long term.

Remember however that short-term measures of return can encourage a company to pursue **short-term** objectives at the expense of **long-term** ones, for example by deferring new capital investments, or spending only small amounts on research and development and on training.

A major problem with setting a number of different financial targets, either primary targets or supporting secondary targets, is that they might not all be consistent with each other. When this happens, some compromises will have to be accepted.

2.3.5 Example: Financial targets

Lion Grange Co has recently introduced a formal scheme of long range planning. Sales in the current year reached $10,000,000, and forecasts for the next five years are $10,600,000, $11,400,000, $12,400,000, $13,600,000 and $15,000,000. The ratio of net profit after tax to sales is 10%, and this is expected to continue throughout the planning period. Total assets less current liabilities will remain at around 125% of sales. Equity in the current year is $8.75m.

It was suggested at a recent board meeting that:

(a) If profits rise, dividends should rise by at least the same percentage

(b) An earnings retention rate of 50% should be maintained ie a payment ratio of 50%

(c) The ratio of long-term borrowing to long-term funds (debt plus equity) is limited (by the market) to 30%, which happens also to be the current gearing level of the company

You are required to prepare a financial analysis of the draft long range plan.

Solution

The draft financial plan, for profits, dividends, assets required and funding, can be drawn up in a table, as follows.

	Current Year	*Year 1*	*Year 2*	*Year 3*	*Year 4*	*Year 5*
	$m	$m	$m	$m	$m	$m
Sales	10.00	10.60	11.40	12.40	13.60	15.00
Net profit after tax	1.00	1.06	1.14	1.24	1.36	1.50
Dividends (50% of profit after tax)	0.50	0.53	0.57	0.62	0.68	0.75
Total assets less current liabilities	12.50	13.25	14.25	15.50	17.00	18.75
Equity (increased by retained earnings)	8.75	9.28	9.85	10.47	11.15	11.90
Maximum debt (30% of long-term funds, or 3/7 × equity)	3.75	3.98	4.22	4.49	4.78	5.10
Funds available	12.50	13.26	14.07	14.96	15.93	17.00
(Shortfalls) in funds *	0.00	0.00	(0.18)	(0.54)	(1.07)	(1.75)

* Given maximum gearing of 30% and no new issue of shares = funds available minus net assets required.

Suggest policies on dividends, retained earnings and gearing for Lion Grange, using the data above.

Answer

The financial objectives of the company are not compatible with each other. Adjustments will have to be made.

(a) Given the assumptions about sales, profits, dividends and net assets required, there will be an **increasing shortfall of funds** from year 2 onwards, unless new shares are issued or the gearing level rises above 30%.

(b) In years 2 and 3, the shortfall can be eliminated by **retaining a greater percentage** of profits, but this may have a serious **adverse effect** on the share price. In year 4 and year 5, the shortfall in funds cannot be removed even if dividend payments are reduced to nothing.

(c) The **net asset turnover** appears to be **low**. The situation would be eased if investments were able to generate a higher volume of sales, so that fewer fixed assets and less working capital would be required to support the projected level of sales.

(d) If asset turnover cannot be improved, it may be possible to **increase the profit to sales ratio** by reducing costs or increasing selling prices.

(e) If a new issue of shares is proposed to make up the shortfall in funds, the amount of funds required must be considered very carefully. Total **dividends** would have to be **increased** in order to pay dividends on the new shares. The company seems unable to offer prospects of suitable dividend payments, and so raising new equity might be difficult.

(f) It is conceivable that extra funds could be raised by issuing new debt capital, so that the level of gearing would be over 30%. It is uncertain whether investors would be prepared to lend money so as to increase gearing. If more funds were borrowed, profits after interest and tax would fall so that the share price might also be reduced.

2.4 Non-financial objectives

A company may have important **non-financial objectives**, which will limit the achievement of financial objectives. Examples of non-financial objectives are as follows.

(a) **The welfare of employees**
A company might try to provide good wages and salaries, comfortable and safe working conditions, good training and career development, and good pensions. If redundancies are necessary, many companies will provide generous redundancy payments, or spend money trying to find alternative employment for redundant staff.

(b) **The welfare of management**
Managers will often take decisions to improve their own circumstances, even though their decisions will incur expenditure and so reduce profits. High salaries, company cars and other perks are all examples of managers promoting their own interests.

(c) **The provision of a service**
The major objectives of some companies will include fulfilment of a responsibility to provide a service to the public. Examples are the privatised British Telecom and British Gas. Providing a service is of course a key responsibility of government departments and local authorities.

(d) **The fulfilment of responsibilities towards customers**
Responsibilities towards customers include providing in good time a product or service of a quality that customers expect, and dealing honestly and fairly with customers. Reliable supply arrangements and also after-sales service arrangements, are important.

(e) **The fulfilment of responsibilities towards suppliers**
Responsibilities towards suppliers are expressed mainly in terms of trading relationships. A

company's size could give it considerable power as a buyer. The company should not use its power unscrupulously. Suppliers might rely on getting prompt payment, in accordance with the agreed terms of trade.

(f) **The welfare of society as a whole**
The management of some companies is aware of the role that their company has to play in exercising corporate social responsibility. This includes compliance with applicable laws and regulations but is wider than that. Companies may be aware of their responsibility to minimise pollution and other harmful 'externalities' (such as excessive traffic) which their activities generate. In delivering 'green' environmental policies, a company may improve its corporate image as well as reducing harmful externality effects. Companies also may consider their 'positive' responsibilities, for example to make a contribution to the community by local sponsorship.

Other non-financial objectives are **growth**, **diversification** and **leadership in research and development**.

Non-financial objectives do not negate financial objectives, but they do suggest that the simple theory of company finance, that the objective of a firm is to maximise the wealth of ordinary shareholders, is too narrow. Financial objectives may have to be **compromised** in order to satisfy non-financial objectives.

3 Stakeholders

FAST FORWARD

Stakeholders are individuals or groups who are affected by the activities of the firm. They can be classified as **internal** (employees and managers), **connected** (shareholders, customers and suppliers) and **external** (local communities, pressure groups, government).

Key term

There is 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.

The various stakeholder groups in a firm can be classified as follows.

Stakeholder groups	
Internal	Employees and pensioners Managers
Connected	Shareholders Debtholders Customers Bankers Suppliers Competitors
External	Government Pressure groups Local and national communities Professional and regulatory bodies

3.1 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 maximise 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 jeopardising 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 minimise the risk of default and will not wish to lend more than is prudent.

(d) **Employees**

Employees will usually want to maximise 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 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.

3.2 Stakeholder groups, strategy and objectives

The actions of stakeholder groups in pursuit of their various goals can exert influence on strategy and objectives. The greater the power of the stakeholder, the greater his influence will be. Each stakeholder group will have different expectations about what it wants, and the **expectations of the various groups may conflict**. Each group, however, will influence strategic decision-making.

3.3 Shareholders and management

Although ordinary shareholders (equity shareholders) are the owners of the company to whom the board of directors are accountable, the actual powers of shareholders tend to be restricted, except in companies where the shareholders are also the directors. 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), there is often apathy and acquiescence in directors' recommendations.

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**, in which managers act as agents for the shareholders.

Key term

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.

However, if managers hold none or very few of the equity shares of the company they work for, what is to stop them from working inefficiently? or not bothering to look for profitable new investment opportunities? **or** giving themselves high salaries and perks?

One power that shareholders possess is the right to **remove** the **directors** from office. But shareholders have to take the initiative to do this, and in many companies, the shareholders lack the energy and organisation to take such a step. Even so, directors will want the company's report and accounts, and the proposed final dividend, to meet with shareholders' approval at the AGM.

Another reason why managers might do their best to improve the financial performance of their company is that managers' pay is often related to the **size** or profitability of the company. Managers in very big companies, or in very profitable companies, will normally expect to earn higher salaries than managers in smaller or less successful companies. There is also an argument for giving managers some **profit-related pay**, or providing incentives which are related to profits or share price.

3.4 Shareholders, managers and the company's long-term creditors

The relationship between long-term creditors of a company, the management and the shareholders of a company encompasses the following factors.

(a) Management may decide to raise finance for a company by taking out long-term or medium-term loans. They might well be taking **risky investment decisions** using outsiders' money to finance them.

(b) Investors who provide debt finance will rely on the company's management to generate enough net cash inflows to make **interest payments on time**, and eventually to repay loans.

However, long-term creditors will often take **security** for their loan, perhaps in the form of a fixed charge over an asset (such as a mortgage on a building). Bonds are also often subject to certain restrictive covenants, which restrict the company's rights to borrow more money until the debentures have been repaid.

If a company is unable to pay what it owes its creditors, the creditors may decide to **exercise their security** or to apply for the company to be **wound up**.

(c) The money that is provided by long-term creditors will be invested to earn profits, and the profits (in excess of what is needed to pay interest on the borrowing) will provide **extra dividends** or retained profits for the shareholders of the company. In other words, shareholders will expect to increase their wealth using creditors' money.

3.5 Shareholders, managers and government

The government does not have a direct interest in companies (except for those in which it actually holds shares). However, the government does often have a strong indirect interest in companies' affairs.

(a) **Taxation**
The government raises taxes on sales and profits and on shareholders' dividends. It also expects companies to act as tax collectors for income tax and VAT. The **tax structure** might influence investors' preferences for either dividends or capital growth.

(b) **Encouraging new investments**
The government might provide **funds** towards the cost of some investment projects. It might also encourage private investment by offering **tax incentives.**

(c) **Encouraging a wider spread of share ownership**
In the UK, the government has made some attempts to encourage more private individuals to become company shareholders, by means of **attractive privatisation issues** (such as in the electricity, gas and telecommunications industries) and tax incentives, such as ISAs (Individual Savings Accounts) to encourage individuals to invest in shares.

(d) **Legislation**
The government also influences **companies**, and the **relationships** between shareholders, creditors, management, employees and the general public, through legislation, including the

Companies Acts, legislation on employment, health and safety regulations, legislation on consumer protection and consumer rights and environmental legislation.

(e) **Economic policy**

A government's economic policy will affect business activity. For example, **exchange rate policy** will have implications for the revenues of exporting firms and for the purchase costs of importing firms. Policies on **economic growth, inflation, employment, interest rates** and so on are all relevant to business activities.

4 Measuring the achievement of corporate objectives

FAST FORWARD

Performance measurement is a part of the system of financial control of an enterprise as well as being important to investors.

4.1 Measuring financial performance

As part of the system of financial control in an organisation, it will be necessary to have 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 income statement of the enterprise.

Exam focus point

Examiners have said, more than once, that knowledge of how to calculate and interpret key ratios is a weak point for many candidates. Make sure that it is one of your strong points. In reviewing ratio analysis below, we are in part revising material included in previous papers including F5.

4.2 The broad categories of ratios

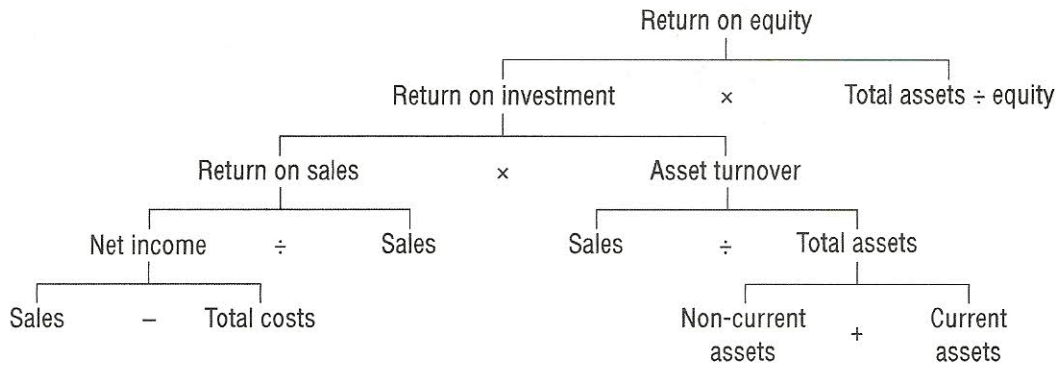
Ratios can be grouped into the following four categories:

- **Profitability and return**
- **Debt and gearing**
- **Liquidity**
- **Shareholders' investment ratios ('stock market ratios').**

The key to obtaining meaningful information from ratio analysis is **comparison**: comparing ratios **over a number of periods** within the same business to establish whether the business is improving or declining, and **comparing ratios between similar businesses** to see whether the company you are analysing is better or worse than average within its own business sector.

4.3 Ratio pyramids

The Du Pont system of ratio analysis involves constructing a pyramid of interrelated ratios like that below.



Such ratio pyramids help in providing for an overall management plan to achieve profitability, and allow the interrelationships between ratios to be checked.

4.4 Profitability

A company ought of course to be profitable if it is to maximise 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

Profit before taxation is generally thought to be a better figure to use than profit after taxation, because there might be unusual variations in the tax charge from year to year which would not affect the underlying profitability of the company's operations

Another profit figure that should be considered is **profit before interest and tax (PBIT)**. This is the amount of profit which the company earned before having to pay interest to the providers of loan capital. By providers of loan capital, we usually mean **longer term** loan capital, such as debentures and medium-term bank loans.

4.4.1 Profitability and return: the return on capital employed

You cannot assess profits or profit growth properly without relating them to the amount of funds (the capital) employed in making the profits. The most important profitability ratio is therefore **return on capital employed (ROCE),** also called **return on investment (ROI).**

Key terms

Return on Capital Employed = $\frac{\text{PBIT}}{\text{Capital employed}}$

Capital employed = Shareholders' funds *plus* payables: amounts falling due after more than one year' *plus* any long-term provisions for liabilities and charges.

= Total assets less current liabilities.

4.4.2 Evaluating the ROCE

What does a company's ROCE tell us? What should we be looking for? There are three comparisons that can be made.

(a) The **change** in ROCE from one year to the next

(b) The ROCE being **earned** by **other companies**, if this information is available

(c) A comparison of the ROCE with **current market borrowing rates**

  (i) What would be the **cost of extra borrowing** to the company if it needed more loans, and is it earning a ROCE that suggests it could make high enough profits to make such borrowing worthwhile?

  (ii) Is the company making a ROCE which suggests that it is making **profitable use** of its **current borrowing**?

4.4.3 Secondary ratios

We may analyse the ROCE by looking at the kinds of interrelationships between ratios used in ratio pyramids, which we mentioned earlier. We can thus find out why the ROCE is high or low, or better or worse than last year. **Profit margin** and **asset turnover** together explain the ROCE, and if the ROCE is the primary profitability ratio, these other two are the secondary ratios. The relationship between the three ratios is as follows.

Profit margin × asset turnover = ROCE

$$\frac{\text{PBIT}}{\text{Sales revenue}} \times \frac{\text{Sales revenue}}{\text{Capital employed}} = \frac{\text{PBIT}}{\text{Capital employed}}$$

It is also worth commenting on the **change in revenue (turnover)** from one year to the next. Strong sales growth will usually indicate volume growth as well as revenue increases due to price rises, and volume growth is one sign of a prosperous company.

Exam focus point

Remember that capital employed is **not just** shareholders' funds; this was highlighted as a frequent mistake in previous exams.

4.4.4 Return on equity

Another measure of the firm's overall performance is **return on equity**. This compares net profit after tax with the equity that shareholders have invested in the firm.

Key terms

$$\textbf{Return on Equity} = \frac{\text{Earnings attributable to ordinary shareholders}}{\text{Shareholders' equity}}$$

This ratio shows the earning power of the shareholders' book investment and can be used to compare two firms in the same industry. A high return on equity could reflect the firm's good management of expenses and ability to invest in profitable projects. However, it could also reflect a higher level of debt finance (gearing) with associated higher risk. (see Section 4.5)

4.4.5 Gross profit margin, the net profit margin and profit analysis

Depending on the format of the income statement, you may be able to calculate the **gross profit margin** and also the **net profit margin**. Looking at the two together can be quite informative.

4.4.6 Example: Profit margins

A company has the following summarised income statements for two consecutive years.

	Year 1	*Year 2*
	$	$
Sales revenue	70,000	100,000
Less cost of sales	42,000	55,000
Gross profit	28,000	45,000
Less expenses	21,000	35,000
Net profit	7,000	10,000

Although the net profit margin is the same for both years at 10%, the gross profit margin is not.

In year 1 it is: $\frac{28{,}000}{70{,}000} = 40\%$ and in year 2 it is: $\frac{45{,}000}{100{,}000} = 45\%$

Is this good or bad for the business? An increased profit margin must be good because this indicates a wider gap between selling price and cost of sales. However, given that the net profit ratio has stayed the same in the second year, expenses must be rising. In year 1 expenses were 30% of turnover, whereas in year 2 they were 35% of turnover. This indicates that administration or selling and distribution expenses may require tighter control.

A percentage analysis of profit between year 1 and year 2 is as follows.

	Year 1	*Year 2*
	%	%
Cost of sales as a % of sales	60	55
Gross profit as a % of sales	40	45
	100	100
Expenses as a % of sales	30	35
Net profit as a % of sales	10	10
Gross profit as a % of sales	40	45

4.5 Debt and gearing ratios

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. **Gearing** is the amount of debt finance a company uses relative to its equity finance.

(a) When a company is heavily in debt, and seems to be getting even more heavily into debt, banks and other would-be lenders are very soon likely to **refuse further borrowing** and the company might well find itself in trouble.

(b) When a company is earning only a modest profit before interest and tax, and has a heavy debt burden, there will be **very little profit** left over for shareholders after the interest charges have been paid.

The main debt and gearing ratios are covered in Chapter 14.

4.6 Liquidity ratios: cash and working capital

Profitability is of course an important aspect of a company's performance, and debt or gearing is another. Neither, however, addresses directly the key issue of **liquidity**. A company needs liquid assets so that it can meet its debts when they fall due. The main liquidity ratios will be described in Chapter 4.

4.7 Shareholders' investment ratios 6/08

FAST FORWARD

Indicators such as **dividend yield, EPS, P/E ratio** and **dividend cover** can be used to assess investor returns.

Returns to shareholders are obtained in the form of **dividends** received and/or **capital gains** from increases in market value.

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.

Information that is relevant to market prices and returns is available from published stock market information, and in particular from certain **stock market ratios**.

Key term

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.

The relationship between the cum div price and the ex div price is:

Market price per share (ex div) = Market price per share (cum div) – forthcoming dividend per share

4.7.1 The dividend yield

Key term

Dividend yield = $\frac{\text{Dividend per share}}{\text{Market price per share}} \times 100$

The dividend yield is the return a shareholder is currently expecting on the shares of a company.

(a) The dividend per share is taken as the dividend for the previous year.

(b) Ex-div means that the share price does not include the right to the most recent dividend.

Shareholders look for **both dividend yield and capital growth.** Obviously, dividend yield is therefore an important aspect of a share's performance.

4.7.2 Example: Dividend yield

Question — **Dividend yield**

In the year to 30 September 20X8, an advertising agency declares an interim ordinary dividend of 7.4c per share and a final ordinary dividend of 8.6c per share. Assuming an ex div share price of 315 cents, what is the dividend yield?

Answer

The total dividend per share is (7.4 + 8.6) = 16 cents

$\frac{16}{315} \times 100 = 5.1\%$

4.7.3 Earnings per share (EPS)

Key term

Earnings per share = $\frac{\text{Profit distributable to ordinary shareholders}}{\text{Weighted average number of ordinary shares}}$

The use of earnings per share was discussed in Section 2.3.3 of this chapter.

4.7.4 The price earnings ratio

Key term

Price earnings ratio = $\frac{\text{Market price of share}}{\text{EPS}}$

The **price earnings (P/E) ratio** is the most important yardstick for assessing the relative worth of a share.

This is the same as:

$\frac{\text{Total market value of equity}}{\text{Total earnings}}$

The **value of the P/E ratio** reflects the **market's appraisal** of the share's **future prospects.** It is an important ratio because it relates two key considerations for investors, the market price of a share and its earnings capacity.

4.7.5 Example: Price earnings ratio

A company has recently declared a dividend of 12c per share. The share price is $3.72 cum div and earnings for the most recent year were 30c per share. Calculate the P/E ratio.

Solution

$$\text{P/E ratio} = \frac{\text{MV ex div}}{\text{EPS}} = \frac{\$3.60}{30c} = 12$$

4.7.6 Changes in EPS: the P/E ratio and the share price 12/08

An approach to assessing what share prices ought to be, which is often used in practice, is a P/E ratio approach.

(a) The relationship between the **EPS** and the **share price** is measured by the **P/E ratio.**

(b) The **P/E ratio** does **not vary much** over time.

(c) So if the **EPS goes up** or **down**, the **share price** should be expected to **move up or down** too, and the new share price will be the new EPS multiplied by the constant P/E ratio.

For example, if a company had an EPS last year of 30c and a share price of $3.60, its P/E ratio would have been 12. If the current year's EPS is 33c, we might expect that the P/E ratio would remain the same, 12, and so the share price ought to go up to $12 \times 33c = \$3.96$.

Exam focus point

The examiner has commented that students have had problems with these ratios and emphasised how important it is to be familiar with them.

Question Shareholder ratios

The directors of X are comparing some of the company's year-end statistics with those of Y, the company's main competitor. X has had a fairly normal year in terms of profit but Y's latest profits have been severely reduced by an exceptional loss arising from the closure of an unsuccessful division. Y has a considerably higher level of financial gearing than X.

The board is focusing on the figures given below.

	X	*Y*
Share price	450c	525c
Nominal value of shares	50c	100c
Dividend yield	5%	4%
Price/earnings ratio	15	25
Proportion of profits earned overseas	60%	0%

In the course of the discussion a number of comments are made, including those given below.

Required

Discuss comments (a) to (d), making use of the above data where appropriate.

(a) 'There is something odd about the P/E ratios. Y has had a particularly bad year. Its P/E should surely be lower than ours'.

(b) 'One of the factors which may explain Y's high P/E is the high financial gearing.'

(c) 'The comparison of our own P/E ratio and dividend yield with those of Y is not really valid. The shares of the two companies have different nominal values.'

(d) 'These figures will not please our shareholders. The dividend yield is below the return an investor could currently obtain on risk-free government bonds.'

Answer

(a) **P/E ratio**

The **P/E ratio** measures the **relationship** between the **market price** of a share and the **earnings per share**. Its calculation involves the use of the share price, which is a reflection of the market's expectations of the future earnings performance, and the historic level of earnings.

If Y has just suffered an abnormally bad year's profit performance which is not expected to be repeated, the market will price the share on the basis of its expected future earnings. The earnings figure used to calculate the ratio will be the historic figure which is lower than that forecast for the future, and thus the ratio will appear high.

(b) **Financial gearing**

The **financial gearing** of the firm expresses the **relationship** between **debt** and **equity** in the capital structure. A high level of gearing means that there is a high ratio of debt to equity. This means that the company carries a high fixed interest charge, and thus the amount of earnings available to equity will be more variable from year to year than in a company with a lower gearing level. Thus the shareholders will carry a higher level of risk than in a company with lower gearing. All other things being equal, it is therefore likely that the share price in a highly geared company will be lower than that in a low geared firm.

The historic P/E ratio is dependent upon the **current share price** and the **historic level of earnings**. A high P/E ratio is therefore more likely to be found in a company with low gearing than in one with high gearing. In the case of Y, the high P/E ratio is more probably attributable to the depressed level of earnings than to the financial structure of the company.

(c) **Comparison of ratios**

The ratios are calculated as follows.

$$\text{P/E ratio} = \frac{\text{Market share price}}{\text{Earnings per share}}$$

$$\text{Dividend yield} = \frac{\text{Dividend per share}}{\text{Market share price}}$$

The **nominal value** of the shares is **irrelevant** in calculating the ratios. This can be proved by calculating the effect on the ratios of a share split - the ratios will be unchanged. Thus if all other factors (such as accounting conventions used in the two firms) are equal, a direct comparison of the ratios is valid.

(d) **Comparison with risk free securities**

As outlined in (c) above, the **dividend yield** is the relationship between the **dividend per share** and the **current market price** of the share. The market price of the share reflects investor expectations about the future level of earnings and growth. If the share is trading with a low dividend yield, this means that investors have positive growth expectations after taking into account the level of risk. Although the government bonds carry no risk, it is equally likely that they have no growth potential either, and this means that the share will still be more attractive even after the low dividend yield has been taken into account.

5 Encouraging the achievement of stakeholder objectives

12/08

5.1 Managerial reward schemes

FAST FORWARD

It is argued that management will only make **optimal** decisions if they are monitored and appropriate incentives are given.

The agency relationship arising from the separation of ownership from management is sometimes characterised as the **'agency problem'**. For example, if managers hold none or very little of the equity shares of the company they work for, what is to stop them from working inefficiently, not bothering to look for profitable new investment opportunities, or giving themselves high salaries and perks?

Key term

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 organisational **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 organisation's goals.

Examples of such remuneration incentives are:

(a) **Performance-related pay**
Pay or bonuses 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.

(c) **Executive share options 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.

5.1.1 Beneficial consequences of linking reward schemes and performance

(a) There is some evidence that performance-related pay does give individuals an incentive to achieve a good performance level.

(b) Effective schemes also attract and keep the employees valuable to an organisation.

(c) By tying an organisation's key performance indicators to a scheme, it is clear to all employees what performance creates organisational success.

(d) By rewarding performance, an effective scheme creates an organisation focused on continuous improvement.

(e) Schemes based on shares can motivate employees/managers to act in the long-term interests of the organisation by doing things to increase the organisation's market value.

5.1.2 Problems associated with reward schemes

(a) A serious problem that can arise is that performance-related pay and performance evaluation systems can **encourage dysfunctional behaviour.** Many investigations have noted the tendency of managers to pad their budgets either in anticipation of cuts by superiors or to make subsequent variances more favourable.

(b) Perhaps of even more concern are the numerous examples of managers making **decisions that are contrary to the wider purposes of the organisation.**

(c) Schemes designed to **ensure long-term achievements** (that is, to combat short-termism) **may not motivate** since efforts and reward are too distant in time from each other (or managers may not think they will be around that long!).

(d) It is questionable whether any performance measures or set of measures can provide a **comprehensive assessment of what a single person achieves** for an organisation. There will always be the old chestnut of lack of goal congruence, employees being committed to what is measured, rather than the objectives of the organisation.

(e) **Self-interested performance** may be encouraged at the **expense of team work**.

(f) High levels of output (whether this is number of calls answered or production of product X) may be achieved at the expense of **quality**.

(g) In order to make bonuses more accessible, **standards and targets may have to be lowered**, with knock-on effects on quality.

(h) They **undervalue intrinsic rewards** (which reflect the satisfaction that an individual experiences from doing a job and the opportunity for growth that the job provides) given that they promote extrinsic rewards (bonuses and so on).

5.2 Regulatory requirements

FAST FORWARD

The achievement of stakeholder objectives can be **enforced** using regulatory requirements such as **corporate governance** codes of best practice and stock exchange **listing regulations**.

5.2.1 Corporate governance

FAST FORWARD

Good corporate governance involves **risk management** and **internal control, accountability** to stakeholders and other shareholders and conducting business in an **ethical and effective way.**

Key term

Corporate governance is the system by which organisations are directed and controlled.

There are a number of 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 enhanced** by **good supervision** and **management** 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, it 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.

Corporate governance codes of good practice generally cover the following areas:

(a) The board should be responsible for taking major **policy** and **strategic** decisions.

(b) Directors should have a **mix of skills** and their **performance** should be assessed regularly.

(c) Appointments should be conducted by formal procedures administered by a **nomination committee**.

(d) **Division of responsibilities** at the head of an organisation is most simply achieved by separating the roles of chairman and chief executive.

(e) **Independent non-executive directors** have a key role in governance. Their number and status should mean that their views carry significant weight.

(f) Directors' remuneration should be set by a **remuneration committee** consisting of independent non-executive directors.

(g) Remuneration should be dependent upon **organisation** and **individual performance**.

(h) Accounts should disclose **remuneration policy** and (in detail) the **packages of individual directors.**

(i) Boards should regularly review **risk management** and **internal control**, and carry out a wider review annually, the results of which should be disclosed in the accounts.

(j) Audit committees of independent non-executive directors should liaise with external audit, supervise internal audit, and review the annual accounts and internal controls.

(k) The board should maintain a regular dialogue with shareholders, particularly institutional shareholders. The annual general meeting is the most significant forum for communication.

(l) Annual reports must **convey** a **fair and balanced view** of the organisation. They should state whether the organisation has complied with governance regulations and codes, and give specific disclosures about the board, internal control reviews, going concern status and relations with stakeholders.

5.2.2 Stock Exchange listing regulations

FAST FORWARD

A stock exchange sets **rules and regulations** to ensure that the stock market operates **fairly** and **efficiently** for all parties involved.

A stock exchange is an organisation that provides a marketplace in which to trade shares. It also sets rules and regulations to ensure that the stock market operates both efficiently and fairly for all parties involved.

The stock exchange operates as two different markets:

- It is a market for issuers who wish to raise equity capital by offering shares for sale to investors (a primary market). Such companies are **listed** on the stock exchange
- It is also a market for investors who can buy and sell shares at any time, without directly affecting the entities in which they are buying the shares (a secondary market)

To be listed on a stock exchange, a stock must meet the **listing requirements** laid down by that exchange in its approval process. Each exchange has its own particular listing requirements; some are more stringent than others. For example, listed companies in the UK are now required to publish a report on directors' remuneration. The report must include details of individual pay packages and justification for any compensation packages given in the preceding year, also comparing packages with company performance. The report must be voted on by shareholders, although the company is not bound by the shareholders' vote.

6 Not-for-profit organisations

FAST FORWARD

Not-for-profit and public sector organisations have their own objectives, generally concerned with **efficient use of resources** in the light of specified targets.

6.1 Voluntary and not-for-profit sectors

Although most people would know one if they saw it, there is a surprising problem in clearly defining what counts as a **not-for-profit (NFP) organisation**. Local authority services, for example, would not be setting objectives in order to arrive at a profit for shareholders, but nowadays they are being increasingly required to apply the same disciplines and processes as companies which are oriented towards straightforward profit goals.

Case Study

Oxfam operates more shops than any commercial organisation in Britain, and these operate at a profit. The Royal Society for the Protection of Birds operates a mail order trading company which provides a 25% return on capital, operating very profitably and effectively.

Key term

Bois proposes that a **not-for-profit organisation** be defined as:' ... an organisation whose attainment of its prime goal is not assessed by economic measures. However, in pursuit of that goal it may undertake profit-making activities.'

The not-for-profit sector may involve a number of different kinds of organisation with, for example, differing legal status – charities, statutory bodies offering public transport or the provision of services such as leisure, health or public utilities such as water or road maintenance.

The tasks of setting objectives and developing strategies and controls for their implementation can all help in improving the performance of charities and NFP organisations.

6.2 Objectives

Objectives will not be based on profit achievement but rather on achieving a **particular response** from various target markets. This has implications for reporting of results. The organisation will need to be open and honest in showing how it has managed its budget and allocated funds raised. **Efficiency and effectiveness** are particularly important in the use of donated funds, but there is a danger that **resource efficiency** becomes more important than **service effectiveness**.

Here are some possible objectives for a NFP organisation.

(a) Surplus maximisation (equivalent to profit maximisation)
(b) Revenue maximisation (as for a commercial business)
(c) Usage maximisation (as in leisure centre swimming pool usage)
(d) Usage targeting (matching the capacity available, as in the NHS)
(e) Full/partial cost recovery (minimising subsidy)
(f) Budget maximisation (maximising what is offered)
(g) Producer satisfaction maximisation (satisfying the wants of staff and volunteers)
(h) Client satisfaction maximisation (the police generating the support of the public)

6.3 Value for money

FAST FORWARD

Value for money is getting the best possible combination of services from the least resources.

It is reasonable to argue that not-for-profit organisations **best serve society's interests** when the **gap** between the **benefits** they provide and the **cost** of providing those benefits is **greatest**. This is commonly termed **value for money** and is not dissimilar from the concept of profit maximisation, apart from the fact that society's interests are being maximised rather than profit.

Key term

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.

(a) **Economy** (spending money frugally)
(b) **Efficiency** (getting out as much as possible for what goes in)
(c) **Effectiveness** (getting done, by means of (a) and (b), what was supposed to be done)

More formally, these criteria can be defined as follows.

Key terms

Effectiveness is the extent to which declared objectives/goals are met.

Efficiency is the relationship between inputs and outputs.

Economy is attaining the appropriate quantity and quality of inputs at lowest cost to achieve a certain level of outputs.

6.4 Example: Economy, efficiency, effectiveness

(a) **Economy.** The economy with which a school purchases equipment can be measured by comparing actual costs with budgets, with costs in previous years, with government/ local authority guidelines or with amounts spent by other schools.

(b) **Efficiency**. The efficiency with which a school's IT laboratory is used might be measured in terms of the proportion of the school week for which it is used.

(c) **Effectiveness.** The effectiveness of a school's objective to produce quality teaching could be measured by the proportion of students going on to higher or further education.

6.5 Performance measures

Value for money as a concept **assumes** that there is a **yardstick** against which to measure the achievement of objectives. It can be **difficult to determine** where there is value for money, however.

(a) Not-for-profit organisations tend to have **multiple objectives**, so that even if they can all be clearly identified it is impossible to say which is the overriding objective.

(b) **Outputs can seldom be measured** in a way that is generally agreed to be meaningful. (Are good exam results alone an adequate measure of the quality of teaching? How does one quantify the easing of pain following a successful operation?) For example, in the National Health Service success is measured in terms of fewer patient deaths per hospital admission, shorter waiting lists for operations, average speed of patient recovery and so on.

Here are a number of possible solutions to these problems.

(a) Performance can be judged in terms of **inputs**. This is very common in everyday life. If somebody tells you that their suit cost $750, for example, you would generally conclude that it was an extremely well-designed and good quality suit, even if you did not think so when you first saw it. The **drawback**, of course, is that you might also conclude that the person wearing the suit had been cheated or was a fool, or you may think that no piece of clothing is worth $750. So it is with the inputs and outputs of a non-profit-seeking organisation.

(b) Accept that performance measurement must to some extent be subjective. **Judgements** can be made **by experts**.

(c) Most not-for-profit organisations do not face competition but this does not mean that they are all unique. Bodies like local governments, health services and so on can **compare** their performance **against each other** and **against the historical results** of their predecessors. **Unit cost measurements** like 'cost per patient day' or 'cost of borrowing one library book' can be established to allow organisations to assess whether they are doing better or worse than their counterparts. Care must be taken not to read too much into limited information, however.

6.6 Example: Performance measures

Although output of not-for-profit organisations is difficult to measure in a way that is generally agreed to be meaningful it is not impossible. Outputs of a university might be measured in terms of the following.

Broader performance measures

- Proportion of total undergraduate population attending the university (by subject)
- Proportion of students graduating and classes of degrees obtained

- Amount of private sector research funds attracted
- Number of students finding employment after graduation
- Number of publications/articles produced by teaching staff

Operational performance measures

- Unit costs for each operating 'unit'
- Staff: student ratios; staff workloads
- Class sizes
- Availability of computers; good library stock
- Courses offered

6.7 Example: Inputs and outputs

Suppose that at a cost of $40,000 and 4,000 hours (**inputs**) in an average year, two policemen travel 8,000 miles and are instrumental in 200 arrests (**outputs**). A large number of **possibly meaningful measures** can be derived from these few figures, as the table below shows.

		$40,000	4,000 hours	8,000 miles	200 arrests
Cost ($)	*$40,000*		$40,000/4,000 = $10 per hour	$40,000/8,000 = $5 per mile	$40,000/200 = $200 per arrest
Time (hours)	*4,000*	4,000/$40,000 = 6 minutes patrolling per $1 spent		4,000/8,000 = ½ hour to patrol 1 mile	4,000/200 = 20 hours per arrest
Miles	*8,000*	8,000/$40,000 = 0.2 of a mile per $1	8,000/4,000 = 2 miles patrolled per hour		8,000/200 = 40 miles per arrest
Arrests	*200*	200/$40,000 = 1 arrest per $200	200/4,000 = 1 arrest every 20 hours	200/8,000 = 1 arrest every 40 miles	

These measures do not necessarily identify cause and effect or personal responsibility and accountability. Actual performance needs to be **compared**:

- With **standards**, if there are any
- With similar **external activities**
- With similar **internal activities**
- With **targets**
- With **indices**
- Over time – **as trends**

Chapter Roundup

- Financial management decisions cover **investment** decisions, **financing** decisions, **dividend** decisions and **risk management.**
- **Strategy** is a course of action to achieve an objective.
- **Corporate objectives** are relevant for the organisation as a whole, relating to key factors for business success.
- 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 **maximise shareholders' wealth**.
- **Stakeholders** are individuals or groups who are affected by the activities of the firm. They can be classified as **internal** (employees and managers), **connected** (shareholders, customers and suppliers) and **external** (local communities, pressure groups, government).
- **Performance measurement** is a part of the system of financial control of an enterprise as well as being important to investors.
- Indicators such as **dividend yield**, **EPS**, **P/E ratio** and **dividend cover** can be used to assess investor returns.
- It is argued that management will only make **optimal** decisions if they are monitored and appropriate incentives are given.
- The achievement of stakeholder objectives can be **enforced** using regulatory requirements such as **corporate governance** codes of best practice and stock exchange **listing regulations**.
- Good corporate governance involves **risk management** and **internal control, accountability** to stakeholders and other shareholders and conducting business in an **ethical and effective way**.
- A stock exchange sets **rules and regulations** to ensure that the stock market operates **fairly** and **efficiently** for all parties involved.
- Not-for-profit and public sector organisations have their own objectives, generally concerned with **efficient use of resources** in the light of specified targets.
- **Value for money** is getting the best possible combination of services from the least resources.

Quick Quiz

1 Give a definition of financial management.

2 What three broad types of decision does financial management involve?

3 What main financial objective does the theory of company finance assume that a business organisation has?

4 If earnings per share fall from one year to the next, so will the level of dividends.

- ☐ True
- ☐ False

5 Tick which are stakeholder groups for a company.

Employees	☐
Ordinary shareholders	☐
The Board of Directors	☐
Trade payables (suppliers)	☐

6 Return on capital employed = $\frac{?}{?}$

7 Which of the following are examples of financial objectives that a company might choose to pursue?

A Provision of good wages and salaries
B Restricting the level of gearing to below a specified target level
C Dealing honestly and fairly with customers on all occasions
D Producing environmentally friendly products

8 **Fill in the blank**

..... is accordance between the objectives of agents acting within an organisation.

9 What are the 'Three Es' of value for money.

E .....

E .....

E .....

10 In the context of managing performance in 'not for profit' organisations, which of the following definitions is incorrect?

A Value for money means providing a service in a way which is economical, efficient and effective.

B Economy means doing things cheaply: not spending $2 when the same thing can be bought for $1.

C Efficiency means doing things quickly: minimising the amount of time that is spent on a given activity.

D Effectiveness means doing the right things: spending funds so as to achieve the organisation's objectives.

Answers to Quick Quiz

1 The management of the finances of an organisation in order to achieve the financial objectives of the organisation.

2 Investment decisions, financing decisions, dividend decisions.

3 To maximise the wealth of the company's ordinary shareholders.

4 False. Dividends may still be maintained from payments out of profits retained in earlier periods.

5 You should have ticked all four boxes.

6 $$\frac{\text{Profit before interest and tax}}{\text{Capital employed}}$$

7 B This is a financial objective that relates to the level of risk that the company accepts.

8 Goal congruence

9 Efficiency. Economy. Effectiveness

10 C Efficiency means doing things well: getting the best use out of what money is spent on

Now try the questions below from the Exam Question Bank

Number	Level	Marks	Time
Q1	Examination	25	45 mins