Chapter 1

FINANCIAL MANAGEMENT OBJECTIVES

1. Introduction

The purpose of this chapter is to explain the nature of financial management and it's importance, both for profit making and for not-for-profit organisations.

2. The nature and scope of financial management

The role of the Financial Manager is to make the right decisions in order to achieve the objectives of the company in the future.

The four key areas that the Financial Manager is concerned with are as follows:

(a) The raising of long-term finance:

The company needs finance for investment and in order to expand. Finance can be raised from shareholders or from debt – it is the job of the Financial Manager to be aware of the different sources of finance and to decide which source to use.

(b) The investment decision:

Decisions have to be made as to where capital is to be invested. For example, is it worth launching a new product? Is it worth expanding the factory? Is it worth acquiring another company?

It is the Financial Manager's role to decide on which criteria to employ in making this kind of investment decision.

(c) The management of working capital:

In order for the company to operate, it will have to accept a certain level of debtors and it will have to carry a certain level of stock.

Although these are needed to operate the business successfully, they require long-term investment of capital that is not directly earning profits.

Debtors and stock are just two components of working capital (working capital = current assets less current liabilities) and it is a job of the Financial Manager to ensure that the working capital is managed properly i.e. that it is high enough to enable to company to operate efficiently, but that it does not get out of control and end up wasting money for the company.

(d) The management of risk:

One of the roles of the Financial Manager is to manage the risk due to changing exchange rates if the business trades abroad, and to manage the risk due to changes in interest rates if the business borrows or deposits money.

3. The relationship between financial management, management accounting and financial accounting

3.1. Management Accounting

As outlined in the previous paragraph, Financial Management is mainly concerned with making decisions for the long-term future of the company.

It tends to be long-term decision making, involves making forecasts for the future and needs much external information (e.g. knowledge of competitors). The purpose is to make decisions which end up achieving the objectives of the company.

Once the long term decisions have been made, they need to be implemented and controlled. This is Management Accounting.

- Management Accounting involves making short-term decisions as to how to implement the long-term strategy and involves the setting up of a control system in order to measure how well objectives are being achieved in order that corrections may be made if necessary.
- It tends to be short-term (the coming year), and involves both past information and forecasts for the future.

3.2. Financial Accounting

- Financial Accounting is the reporting to stakeholders – primarily shareholders – of how the company has performed and therefore effectively how well the Financial Manager and Management Accountant are doing their jobs.
- The Financial Accountant is fulfilling a legal requirement to report the profits, and it is not their role to look for ways of performing better – that is the job of the Financial Manager.
- The Financial Accountant is only looking at past information and information internal to the company.

4. The relationship of financial objectives and organisational strategy

4.1. A strategy is the course of action taken in order to attempt to achieve an objective.

The Financial Manager needs to decide on strategies for the raising of finance, for the investment of capital, and for the management of working capital.

However, before he can decide on these strategies he needs to identify what the objectives of the company are.

All private sector companies will have the objective of being profitable, but this objective can be stated in various ways (e.g. maximising the return on capital employed; maximising the dividend payable to shareholders). The objectives are different for the various stakeholders in a company (e.g. the shareholders, the debt lenders, the employees) and it is the objectives that will determine the strategies to be followed.

4.2. Maximising and Satisficing

One problem for the Financial Manager (as discussed more in the next paragraph) is to satisfy the objectives of several stakeholders at the same time. For example, reducing wages might increase profits and might satisfy shareholders, but would be unlikely to satisfy employees!

It is up to the Financial Manager to consider the various stakeholders and their objectives and decide on a strategy to achieve the relevant objectives. It is however obviously often difficult to satisfy everyone at the same time.

Maximising is finding the best possible outcome, whereas **satisficing** is finding simply an acceptable or adequate outcome.

5. Multiple stakeholders.

As stated in the previous paragraph, there are several stakeholders in a company and this presents a problem for the Financial Manager in deciding which stakeholder objectives are the more important and how to satisfy several different types of stakeholder at the same time.

5.1. Examples of stakeholders are as follows:

Internal:

- Employees
- Managers

Connected:

- Shareholders
- Debt Lenders
- Customers
- Bankers
- Suppliers

External:

- Government
- Local communities
- The community at large

The influence of the various stakeholders results in many firms adopting **non-financial objectives** in addition to financial ones.

5.2. These might include objectives such as:

- Maintaining a contented workforce
- Showing respect for the environment
- Providing a top quality service to customers

6. Objectives (financial and otherwise) in not-for-profit organisations

6.1. 'Not-for-profit'

- 'Not-for-profit' organisations include organisations such as charities, which are not run to make profits but to provide a benefit to specific groups of people.
- 'Not-for-profit' also includes such things as the state health service and police force, where again they are not run to make profits, but to provide a benefit.
- Although good financial management of these organisations is important, it is not possible to have financial objectives of the same form as for companies. This is partly because it is not so clear-cut as to in whose interest the organisation is run. Also, the most obvious financial measures – those related to profitability – are clearly not appropriate. Costs may be measured relatively easily, but the benefits – such as better healthcare – are intangible.
- The focus therefore for these organisations in on **value for money** i.e. attempting to get the maximum benefits for the least cost.

6.2. The fundamental components of Value for Money are:

- Economy i.e. obtaining resources at a 'fair' price.

  Ways of achieving this are:
  - putting out to tender (in the case of equipment)
  - benchmarking i.e. comparing with private sector organizations (in the case of wages)
- Effectiveness i.e. obtaining good results
  - In the case of a hospital (for example) one way of attempting to measure this could be to calculate the death rate per 1000 patients.
- Efficiency i.e. making good use of resources
  - Again, in the case of a hospital one way of attempting to measure this could be to calculate the number of patients per nurse.

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