TOPIC 3

FINANCE

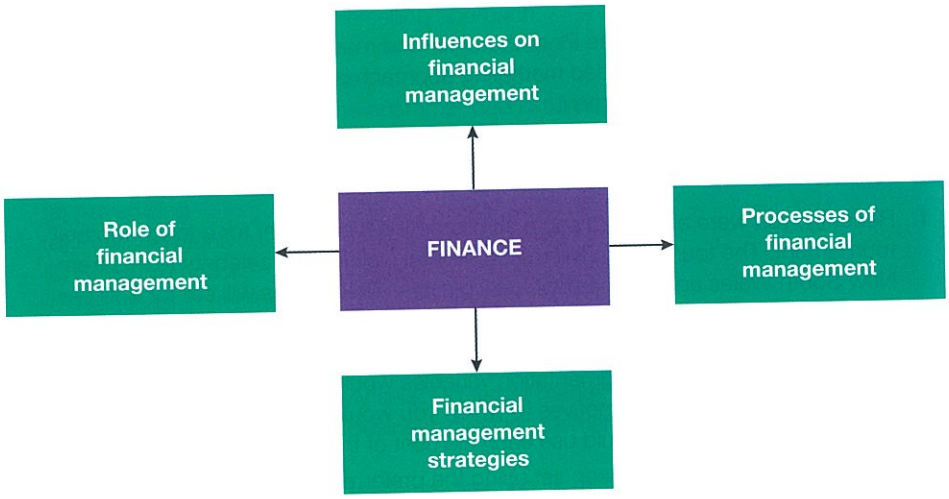
FOCUS AREA

The focus of this topic is the role of interpreting financial information in the planning and management of a business.

OUTCOMES

Students should be able to:

- evaluate management strategies in response to changes in internal and external influences
- discuss the social and ethical responsibilities of management
- analyse business functions and processes in large and global businesses
- explain management strategies and their impact on businesses
- evaluate the effectiveness of management in the performance of businesses
- plan and conduct investigations into contemporary business issues
- organise and evaluate information for actual and hypothetical business situations
- communicate business information, issues and concepts in appropriate formats
- apply mathematical concepts appropriately in business situations.



Nationwide — assisting clients achieve their financial goals

Nationwide, founded in 1989, have over 20 years' experience in the financial services industry. They provide a range of integrated financial services including financial planning, lending, insurance, accounting and taxation. One of their main aims is to assist their clients achieve their financial goals through the range of their financial solutions.

While their employees have a wealth of experience, it is crucial they are always aware of and responsive to compliance and legislative changes. When new tax, superannuation measures or other financial policies or legislation are introduced, Nationwide ensure their staff are fully informed about the regulatory requirements so they can then provide practical advice and guidance for their clients and assist them respond to these changes.

The Australian Securities and Investments Commission (ASIC) is the government body that regulates financial services organisations and professionals, which means they have a large influence on Nationwide. As the financial services regulator, ASIC licenses and monitors Nationwide to ensure they meet the standards set out in various pieces of legislation and certifies that they are operating efficiently, fairly and honestly.

As a large proportion of Nationwide's clientele are companies, they are obligated to pay company tax. Nationwide's tax professionals provide guidance on how their clients can maximise their financial position, in particular, through tax planning. They help businesses achieve their full potential through the recommendation of tax effective strategies and assist them in structuring their business more efficiently so they can manage the amount of tax they pay.

Another service provided at Nationwide is investment planning, which means that global market influences have an impact on the advice and recommendations Nationwide provide. Nationwide's staff periodically analyse the issues and trends affecting the global economy and predict how this will have an impact on their clients.

Since the global financial crisis, there has been a lot of business uncertainty. The uncertainties in the global economy have also had an impact on the liquidity and profitability of some of Nationwide's corporate clients. To manage this, staff assist clients in implementing effective working capital management strategies in an effort to help them improve their cash flow and current ratio.

One of Nationwide's aims is to assist companies maximise profitability. To achieve this, Nationwide uses updated accounting software that allows them to prepare detailed financial statements. They also use a variety of tools to perform ratio and benchmarking analysis to assist businesses review their current position. Through the scope of their integrated financial solutions they are able to help their clients achieve their financial goals and grow their wealth.



'The uncertainties in the global economy have had an impact on the liquidity and profitability of Nationwide's clients.'

on Resources

Kathmandu case study: Finance (doc-14391)

CHAPTER 9

Role of financial management

OVERVIEW

9.1 Introduction
9.2 Strategic role of financial management
9.3 Objectives of financial management
9.4 Interdependence with other key business functions

9.1 Introduction

BizWORD

Financial management *is the planning and monitoring of a business's financial resources to enable the business to achieve its financial objectives.*

Financial management is the planning and monitoring of a business's financial resources to enable the business to achieve its financial objectives. Financial management is crucial if a business is to achieve its financial goals. The mismanagement of financial resources can lead to problems.

9.2 Strategic role of financial management

BizWORD

Strategy *refers to long-term, broad aims affecting all key business areas; that is, the strategic role of each key business function involves the managers of each function contributing to the strategic direction or strategic plan of the business.*

Businesses have specific goals they wish to achieve in relation to investment in capital (machinery and technology), training staff, marketing and the expansion of operations. The strategies that a business adopts work towards achieving its goals both in the short and longer term. **Strategy** refers to long-term, broad aims affecting all key business areas; that is, the strategic role of each key business function involves the managers of each function contributing to the strategic direction or strategic plan of



FIGURE 9.1 The strategic role of financial management refers to the specific planning and management of a business's financial resources in order to assist the business achieve its objectives.

the business. Developing a **strategic plan** as part of a business's financial management will ensure that the business survives and grows in the competitive business world. Strategic plans encompass a long-term view of where the business is going, how it will get there and a monitoring process to keep track of progress along the way.

The long-term or strategic role of financial management is to ensure that a business achieves its goals and objectives. This can only be accomplished if the business's finances are managed effectively.

The strategic role of financial management includes:

- setting financial objectives and ensuring the business is able to achieve these goals
- sourcing finance
- preparing budgets and forecasting future finances
- preparing financial statements
- maintaining sufficient cash flow
- distributing funds to other parts of the business.

BizWORD

Strategic plan *encompasses the strategies that a business will use to achieve its long-term goals.*



BizFACT

Thirty-three per cent of small businesses fail due to poor management of financial resources.

FIGURE 9.2 Money (finance) is needed both to start a business and to keep it operating. Many businesses have failed because they mismanaged their financial resources. Proper financial management, however, can ensure that objectives and goals are achieved.

Strategic planning of **financial resources** is essential to a business's success and growth (see the following Snapshot).

BizWORD

Financial resources *are those resources in a business that have a monetary or money value.*

SNAPSHOT

Financial plans



Businesses that put together a realistic financial plan are more likely to gain the finance they need to grow and endure the difficulties that inevitably crop up.

Most business owners will create a business plan that sets out the desired goals and direction of the business. While no two business plans are alike, most business plans will include some common elements such as goals, operational plans, marketing plans and human resource plans. The financial section of the business plan, however, is one of the most fundamental sections of the plan. This is because the other sections of the plan won't mean a thing if they can't be justified with the correct figures.

"The financial section of the business plan ... is one of the most fundamental sections of the plan."

There are two very important reasons why business owners need a financial plan. They will need to have a financial plan if they intend on seeking finance. Financial institutions, investors or other lenders are going to want to see evidence that supports the fact that the business is likely to grow and make a profit, and that it will be able to make repayments.

The other reason that a financial plan is crucial is to help the owners predict how their business will do. The financial plan will give them an indication as to whether the business will be viable or whether they are wasting their time and/or money.

What should the financial section of a business plan include? To begin with, the financial plan should include financial projections. For example, it should include a sales forecast, an expenses budget, cash flow projection, income projection, a balance sheet and a break-even analysis. While there is a temptation to be overly optimistic when forecasting in an attempt to attract investors, it is important that the owners be realistic.

Once the financial plan has been created, it is important that owners continuously review and revise their plan and don't forget about it. The owners or financial managers should continuously work out the actual figures and compare them with their projections. They should then use those comparisons to revise their financial plan for the future.

SNAPSHOT QUESTIONS

1. **Identify** some common elements of a business plan.
2. **Why** is the financial plan the most important element of the business plan?
3. **Outline** what should be included in the financial plan.

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Concept 1

Strategic role of financial management
Summary screen and practice questions

9.3 Objectives of financial management

For a business to achieve its longer term goals it must have a number of short-term, specific objectives. The objectives of financial management are to maximise the business's:

- profitability
- growth
- efficiency
- liquidity
- solvency.

The responsibility of financial management is to make decisions about the best way to achieve those objectives. This will involve identifying and evaluating alternative courses of action and making recommendations.

9.3.1 Profitability

BizWORD

Profitability *means the excess of revenue or income over expenses or costs.*

Profitability is another important financial objective of management. Profitability is the ability of a business to maximise its profits. Profits satisfy owners or shareholders in the short term but are also important for the longer term sustainability of a firm.

To ensure that profit is maximised, a business must carefully monitor its revenue and pricing policies, costs and expenses, inventory levels and levels of assets. Profitability will be examined in more detail in chapter 11.

9.3.2 Growth

BizWORD

Growth *is the ability of the business to increase its size in the longer term.*

Growth is the ability of the business to increase its size in the longer term. Growth of a business depends on its ability to develop and use its asset structure to increase sales, profits and market share. Growth is an important financial objective of management as it ensures that the business is sustainable into the future.



FIGURE 9.3 In order to achieve their global target of generating €50 billion in sales by 2020, IKEA set an objective of increasing growth by 8 per cent each year. To achieve this, the furniture store will be expanding into India and China, where they plan on opening 25 stores by 2025.

9.3.3 Efficiency

Efficiency is the ability of a business to minimise its costs and manage its assets so that maximum profit is achieved with the lowest possible level of assets.

Efficiency generally relates to the operations or revenue-producing activities of the business. Achieving efficiency requires a firm to have control measures in place to monitor assets. A business that aims for efficiency must monitor the levels of inventories and cash and the collection of receivables. Efficiency will be examined in more detail in chapter 11.

BizWORD

Efficiency *is the ability of a business to minimise its costs and manage its assets so that maximum profit is achieved with the lowest possible level of assets.*

9.3.4 Liquidity

Liquidity is an important financial objective of management. Liquidity is the extent to which a business can meet its financial commitments in the short-term (less than 12 months). A business must have sufficient cash flow to meet its financial obligations or be able to convert current assets into cash quickly, for example, by selling inventory.

Controls over the flow of cash into and out of the business ensure that it has supplies of cash when needed. Cash shortfalls and excess or idle cash must be avoided as both involve loss of profitability for a business. Liquidity will be examined in more detail in chapter 11.

BizWORD

Liquidity *is the extent to which a business can meet its financial commitments in the short term (less than 12 months).*

9.3.5 Solvency

Solvency is the extent to which the business can meet its financial commitments in the longer term (more than 12 months). Solvency is particularly important to the owners, shareholders and creditors of a business because it is an indication of the risks to their investment.

Solvency indicates whether a business will be able to repay amounts that have been borrowed for investments in capital (such as equipment and machinery and/or premises). A good indicator to measure solvency is to use **gearing**,

BizWORD

Solvency *is the extent to which the business can meet its financial commitments in the longer term (more than 12 months).*

Gearing *is the proportion of debt (external finance) and the proportion of equity (internal finance) that is used to finance the activities of a business. Gearing ratios determine the firm's solvency.*

which measures the percentage of the assets of the business which are funded by external sources. This way, it measures the business's reliance on outside finance. Solvency (as measured by the level of gearing) is examined in more detail in chapter 11.

9.3.6 Short-term and long-term financial objectives

study on
Syllabus area 3
Topic 1
Concept 2
Objectives of financial management
Summary screen and practice questions

The financial objectives of a business are based on the goals of its strategic plan, which can be translated into both the short and long term.

- *Short-term financial objectives* are the tactical (one to two years) and operational (day-to-day) plans of a business. These would be reviewed regularly to see if targets are being met and if resources are being used to the best advantage to achieve the objectives. For example, if management has a goal to achieve a 15 per cent increase in profit for the next 10 years, the tactical plans might involve purchasing additional machinery, updating old equipment with new technologies, expanding into new markets and providing new services.
- *Long-term financial objectives* are the strategic plans of a business. They are determined for a set period of time, generally more than five years. They tend to be broad goals such as increasing profit or market share, and each will require a series of short-term goals to assist in its achievement. The business would review their progress annually to determine if changes need to be implemented.

9.3.7 Potential conflicts between short-term and long-term financial objectives

Many business objectives complement each other and meet the needs of a broad range of stakeholders. However, sometimes potential conflicts can arise between short-term and long-term financial objectives. For example, a common financial long-term objective is growth. The decision to expand would have the support of managers, employees, suppliers and the local community. However, expansion is often associated with increased costs and gearing, which will lead to lower overall profits in the short term. This decision may therefore cause conflict with the business owners or shareholders as well as investors. In the longer term, however, most business owners would be pleased to support an expansion if it increases the overall value of the business.

Another example that illustrates the conflict between short-term and long-term financial objectives would be the decision to invest in research and development. Investing in research is very expensive and it might take many years to achieve useful results. Therefore, it is a strategy that is bad in the short term, but in the long run, can make the company lots of money.

The conflict between short-term versus long-term results is critical in business. This is because in order to achieve long-term profitability, businesses need to invest in human and physical resources. Many of these resources cost money and will take a long time to pay off, therefore minimising the business's ability to meet their short-term obligations.

Reconciling these conflicting goals is not always easy and short-term thinking by managers may discourage important long-term investment in the business, which could have led to increased profits. Financial managers must constantly assess the achievement of the specific objectives and attempt to satisfy as many goals as possible.

Case study: Wesfarmer's — conflict between short-term and long-term objectives

Can you sacrifice temporary pleasure for long-term gain? Just as you will encounter many opportunities for short-term pleasure that may delay or prevent you from achieving your long-term goals, many business managers sacrifice the long-term health of their business to achieve quick results.

In contrast to this trend, Wesfarmers (which owns companies such as Coles, Bunnings, Officeworks and Target) announced that it would sacrifice short-term profit growth by reducing prices across all their retail businesses in order to guarantee long-term sales growth and shareholder returns. In order to stay competitive, the company will continue to cut prices, which will result in less profit in the short-term. This short-term sacrifice should, however, lead to longer term growth.

According to the managing director, Richard Goyder, 'We'll continue to invest in pricing ... if that moderates our profit increases that's fine as far as I'm concerned because we'll build a strong business'. 'We will always run the group with a long term view — it would be easy to pull some levers and increase short-term profit but that would be bad, something we've never done and never will', Mr Goyder said. 'We won't do what the UK (grocers) did ... if you (focus on) short-term profits you end up with a big problem', he said.

'Both [Coles and Bunnings] could ratchet up prices and we could get earnings growth up, but the businesses would long-term suffer, and that's definitely not the way we do things.'

Source: Quoted material from Sue Mitchell, 'Wesfarmers sacrifices short-term profit for long-term growth', *The Sydney Morning Herald*, 19 February 2015

SNAPSHOT QUESTIONS

1. **Identify** your long-term goals as well as the obstacles that could give you short-term satisfaction but will delay you from achieving those goals.
2. **How** does Wesfarmers deal with the conflict between short-term and long-term objectives?

SNAPSHOT



'... short-term sacrifice should ... lead to longer term growth ...'

9.4 Interdependence with other key business functions

The key business functions include:

- operations
- marketing
- finance
- human resources.

Interdependence refers to the mutual dependence that the key functions have on one another. They key functions work best when they overlap and employees work towards common goals. Each function area depends on the support of the others if it is to perform at capacity.

The marketing, operations and human resources departments rely on financial managers to allocate them adequate funds i.e. the operations department requires funds to purchase inputs and carry out their transformation processes, the marketing department requires funds to undertake the various forms of promotion and the human resources department requires funds in order to pay for staff.

In return, the finance department also relies on the other three key business functions. The finance department relies on operations to produce the products, on

BizWORD

Interdependence *refers to the mutual dependence that the key business functions have on one another.*

marketing to promote the products and on human resources to manage staff. Each of these functions helps the business generate sales and therefore provide income to the finance department.

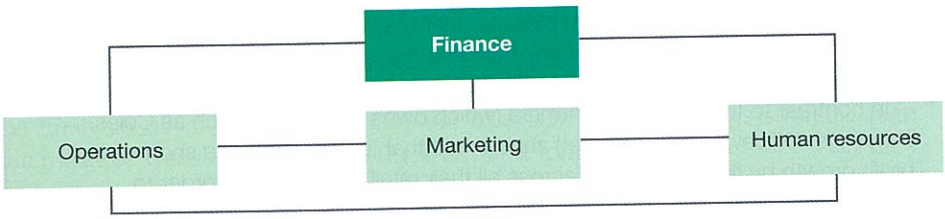


FIGURE 9.4 Without finance there would be very little business. Finance (funding) flows to each functional area within a business, which enables it to achieve its goals.

SUMMARY

- Financial management is the planning and monitoring of a business's financial resources in order to allow the business to achieve its financial objectives.
- The long-term or strategic role of financial management is to ensure that a business achieves their goals and objectives.
- The goals of a business can include increasing market share and profits. These goals are translated into objectives that aim to provide greater details and outcomes. This means they can be measured and evaluated for current and future plans.
- The main objectives of financial management include profitability, growth, efficiency, liquidity and solvency.
- The short-term objectives of a business include both tactical and operational plans of a business, which would be reviewed regularly to determine if targets are being met.
- The long-term objectives of a business include strategic plans of a business and are set for periods of more than five years. They form the basis on which all short-term goals are established.
- While many business objectives complement each other, sometimes, potential conflicts can arise between short-term and long-term financial objectives.
- Interdependence of the key business functions means that each function is not able to operate in isolation successfully — it relies on the others to perform its role in achieving the broader goals of a business.
- Finance plays a crucial role in funding extra resources.

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Syllabus area 3
Topic 1
Concept 3

Interdependence with key business functions
Summary screen and practice questions

EXERCISE 9.1 REVISION

1. **Define** the terms 'financial management'.
2. **Outline** the benefits of developing a strategic plan as part of a business's financial management.
3. **Construct** a concept map **summarising** the strategic roles of financial management.
4. **State**, with examples, the objectives of financial management.
5. **Outline** the relationship between short-term and long-term financial objectives.
6. **Why** is the financial function critical to the long-term success of a business? In your answer, refer to the interdependent nature of the key business functions.
7. **Demonstrate** potential conflicts between short-term and long-term financial objectives.

on Resources

- **Digital doc:** Chapter summary (doc-24811)
- **Interactivity:** Chapter crossword (int-7165)
- **Interactivity:** Multiple choice quiz (int-7166)

EXERCISE 9.1 EXTENSION

1 Using an example, **outline** a conflict between a short-term and long-term objective and **recommend** a strategy that management could adopt to reconcile this conflict.

2 Use the internet to **examine** the annual reports of three businesses.
   (a) **Identify** two goals.
   (b) **Describe** the strategies used to achieve these goals.
   (c) **Propose** reasons why some of the goals may not have been achieved in that financial year.

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