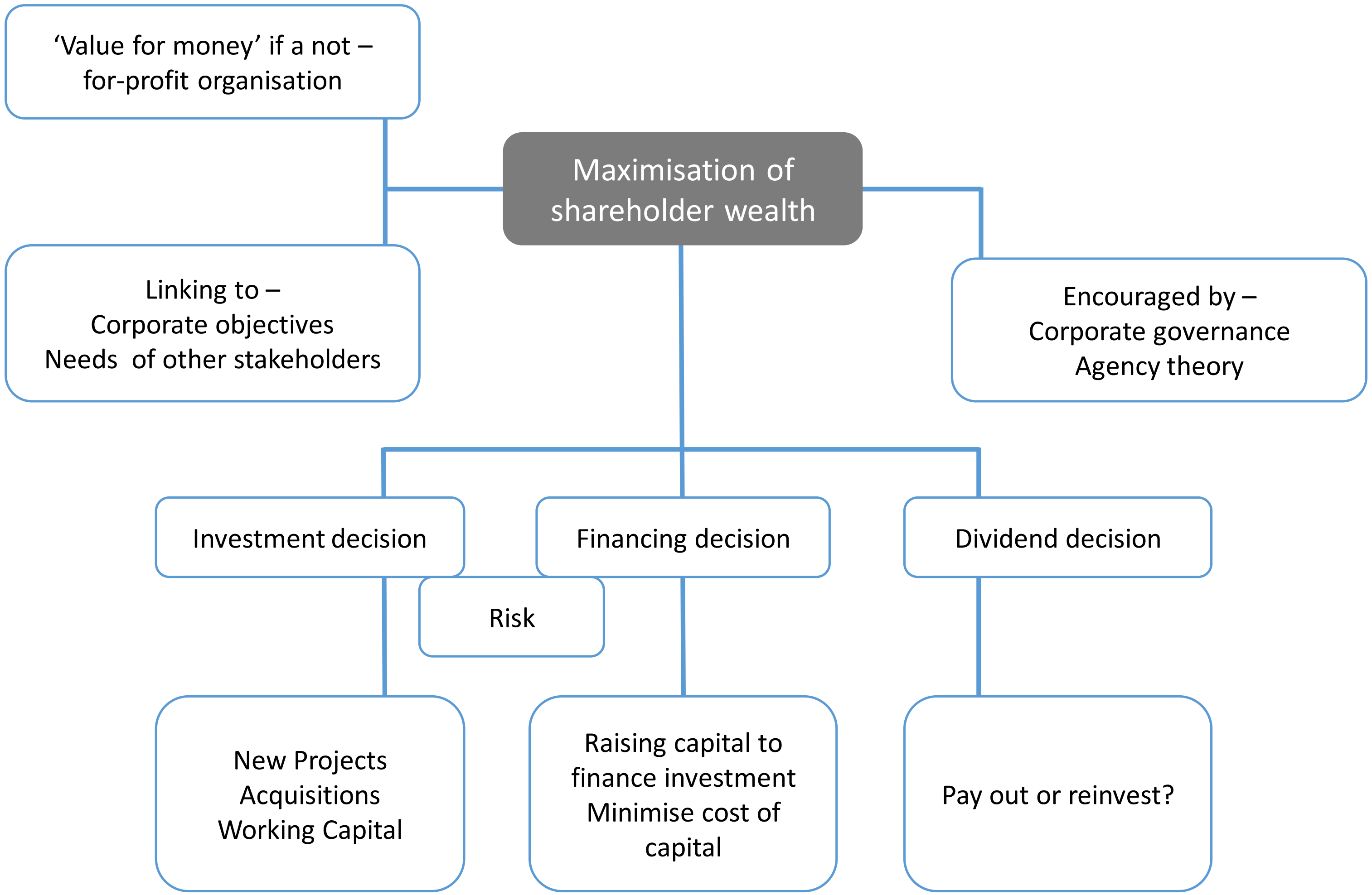
Chapter 1

Financial management and financial objectives

- The nature and purpose of financial managem
- Financial objectives and the relationship with corporate strategy
- Stakeholders
- Measuring the achievement of corporate obje
- Encouraging the achievement of stakeholder objectives
- Not-for-profit organisations

Overview 1



'Value for money' if a not –
for-profit organisation
Maximisation of shareholder wealth
Linking to –
Corporate objectives
Needs of other stakeholders
Encouraged by –
Corporate governance
Agency theory
Investment decision
Financing decision
Dividend decision
Risk
New Projects
Acquisitions
Working Capital
Raising capital to finance investment
Minimise cost of capital
Pay out or reinvest?

Overview 2

Reporting / monitoring

Financial accounting
Management accounting

Syllabus learning outcomes (1)

- The nature and purpose of financial management.
- The relationship between financial management and financial and management accounting.
- The relationship between financial objectives, corporate objectives and corporate strategy.
- Variety of financial objectives, including:

  (i) Shareholder wealth maximisation

  (ii) Profit maximisation

  (iii) Earnings per share growth

Syllabus learning outcomes (2)

- The range of stakeholders and their objectives.
- Possible conflict between stakeholder objectives.
- Role of management in meeting stakeholder objectives, including the application of agency theory.
- Ways of measuring achievement of corporate objectives including:

  (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

Syllabus learning outcomes (3)

- Ways to encourage the achievement of stakeholder objectives, including:
  (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

- Impact of not-for-profit status on financial and other objectives.
- Nature and importance of Value for Money as an objective in not-for-profit organisations.
- Ways of measuring the achievement of objectives in not-for-profit organisations.

Key models and theories

The key models relating to financial management and financial objectives address:

- How corporate objectives link to financial objectives
- The requirements of different stakeholders
- How the objectives of not-for-profit organisations differ from those of profit seeking organisations

Introduction to financial management

- Financial management decisions cover
  - Investment decisions
  - Financing decisions
  - Dividend decisions
- 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.*

Question to consider

Financial management is also relevant to not-for profit organisations.

What might *financial* objectives be in a not-for-profit organisation such as:

(a) A hospital?

(b) A school?

(c) A government department?

Answer

Organisation	Possible financial objectives
Hospital	To stay within its budget To ensure new investment in buildings and equipment is controlled and justified To control inventory well (eg drugs)
School	To stay within its budget To allocate funds to different subjects
Government department	To stay within budget To control expenditure To evaluate expenditure

Not-for-profit financial management

Here are extracts from a children's hospital annual report:

- The Trust pursued productivity and efficiency savings …without any impact on our clinical services.
- Throughout the period the Trust maintained strong controls on capital expenditure and working capital.
- Surplus funds are lodged with counterparty banks through the Government Banking Service.

Financial management

To achieve its objectives, whether for a profit seeking or not-for-profit organisation, financial management can be divided into three main functions:

- Financial planning
- Financial control
- Financial decisions

Financial planning (1)

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.

Short term

Funds may be needed to pay for inventory or to smooth out changes in receivables, payables and cash.

Here, the financial manager is ensuring that *working capital* requirements are met.

Financial planning (2)

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.

Medium or long term

The organisation may have planned purchases of non-current assets such as plant and equipment. The financial manager will analyse financial data to determine which uses of funds best meet the organisation's financial objectives.

Is project A or project B better? Should a new asset be bought or leased?

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.

Financial decisions

The financial manager makes decisions relating to financing, investment, dividends and risk.

- Investments in assets must be financed somehow, for example loans or share capital.
- How should those funds be used?
- Should some parts of the organisation be closed?
- How much profit should be paid back to investors (dividends) to attract investors, but to leave enough finance in the company?
- How can risks such as foreign currency risks be managed?

Accounting and financial management

Financial accounting reports to shareholders on historic information and performance of organisations.

Management accounting reports internally on both historic performance and future plans.

Financial management is ensuring adequate funds are in place and controlled to ensure stakeholder objectives are met where possible.

The financial management function provides information on, for example, projected cash flows to aid the effective management of finance.

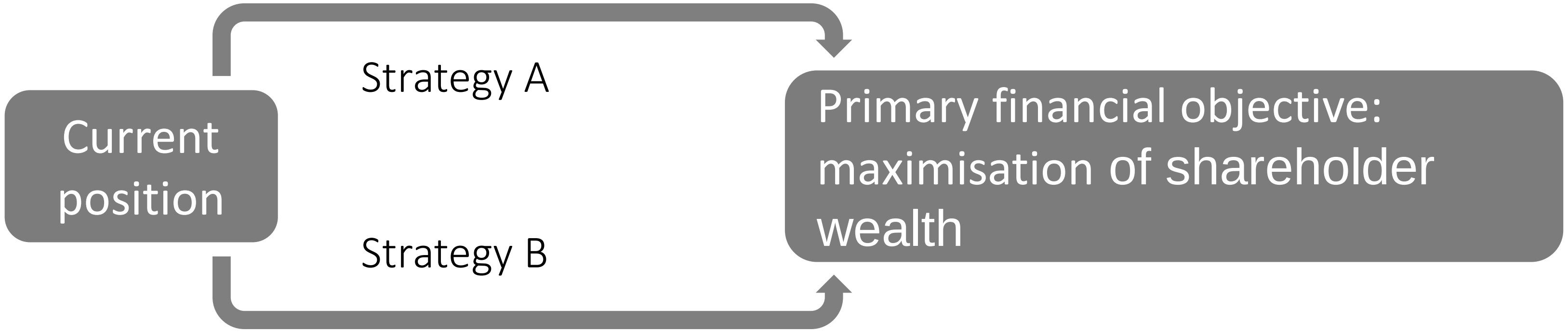
Corporate objectives and strategy (1)

Objectives are the *destination.*

Strategy is a *course of action* to achieve an objective.

As mentioned, the usual assumption in the private sector is that the primary financial objective is to maximise shareholders' wealth.

Corporate objectives and strategy (2)



Corporate strategy: 'is concerned with the overall purpose and scope of the organisation and how value will be added to the different parts of the organisation. '

Corporate objectives and strategy (3)

Primary financial objective: maximisation of shareholder wealth.

This depends on subsidiary financial objectives being met, such as high sales, low material and labour costs, low taxation.

In turn these depend on meeting certain key factors such as: market share and growth, customer satisfaction, the quality of the firm's products, industrial relations, brand strength.

Question: what is shareholder wealth?

It has been stated that the prime objective of most private sector companies is to 'maximise shareholder wealth'.

What do you think this means? What do you think is meant by 'shareholder wealth'?

Answer

Maximising shareholder wealth usually means maximising the total of:

- the share price, plus

- dividends (a transfer of cash from the company to shareholders)

A company can therefore maximise shareholder wealth by a mix of share price increase and paying dividends.

Long term, these depend on the company earning profits that generate a strong net cash inflow.

Question: share price and dividends

Imagine two companies:

Company A always pays all of its profits out as dividends.

Company B always retains all of its profits.

How are their share prices likely to change over time?

Answer

Company A
If all profits are paid out as dividends, nothing can be reinvested in new profit-earning assets. Profits can therefore not grow, nor can dividends, nor can share price. Shareholders are wealthier because of their dividends.

Company B
Profits can be reinvested in profit-earning assets. The company's assets and profits will grow and so the share price should increase. Shareholder wealth is locked up in the company.

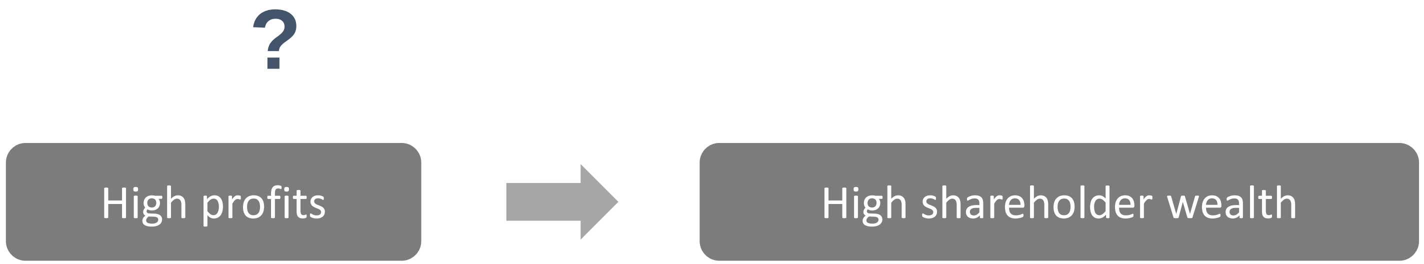
Financial objectives

Although maximising shareholder wealth is usually the overriding objective, subsidiary measures have to be used to indicate if that is likely to happen. The following financial measures can be considered:

- Profits (earnings)
- Earnings per share
- Dividend per share
- Profit retention
- Gearing level
- Operating profitability

Profit maximisation

Maximising shareholder wealth is often assumed to happen if a company *maximises profits:* high profits allow either high dividends or high reinvestment or a mix.



However, the maximisation of profits is not *sufficient* to ensure wealth maximisation.

Question: profits and shareholder wealth

Why might high profits not necessarily mean that shareholder wealth is increased?

Answer

High profits do not necessarily lead to high shareholder wealth because:

- Profits are usually short term measures (one year) and are subject to short term influences.
- Profits can be manipulated eg altering depreciation, capitalising expenditure instead of writing it off.
- Some important expenditure can be postponed, such as research and development, repairs, training. This will hurt companies in the long term.
- Shareholder wealth also depends on the risk associated with the company's undertakings.

Earnings per share

- Earnings per share (EPS) is widely used as a measure of a company's performance.
- 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.
- Earnings per share = net profit or loss attributable to ordinary shareholders (after tax) divided the weighted average number of ordinary shares.
- Can’t compare EPS of different companies as it depends on the nominal value of shares/no of shares issued.

Question: earnings per share

Pre-tax profits = $12,000,000

Tax rate = 30%

Shares: 1 million 8% $1 preference shares and 20 million $1 ordinary shares.

What are the earnings per share?

A 39.6c

B 41.6c

C 42.0c

D 60.0c

Answer

Pre-tax profits = $12,000,000. Tax rate = 30%. Shares: 1 million 8% $1 preference shares and 20 million $1 ordinary shares. What are the earnings per share?

	$
Pre tax profits	12,000,000
Less: Tax @ 30%	3,600,000
Profits after tax	8,400,000
Less: Preference dividends	80,000
Available for ordinary shareholders	8,320,000

B EPS = 8,320,000/20,000,000 = 41.6c

Incorrect answers:

A = [(12m × 0.7) – 0.08m]/21m = 39.6c

C = (12m × 0.7)/20m = 42.0c

D = 12m / 20m = 60.0c

Dividend per share

- Shareholders always look closely at this because they look forward to receiving the dividend.

- However, as a long term measure, dividend per share is flawed as it depends on the discretion of the directors.

- Directors will often try to maintain dividend payments even if earnings (profits) fall as this might prevent shareholder unrest.

Profit retentions

A target for profit retentions can be set. This prevents dividends being so high that the company fails to reinvest for the future.

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, 4 times.

Gearing

Gearing is the ratio of long term debt to equity finance.

- High gearing implies high interest payments made and hence high risk that the company defaults.
- A restriction on the company's level of gearing can therefore be a valid financial objective to keep risk at reasonable levels. For example:

  (i) The ratio of long-term debt capital to equity capital should never exceed, say, 1:2.

  (ii) Interest payments should never be higher than, say, 20% of total profits before interest and tax. This would give a minimum interest cover of 5 (the number of times interest could be paid).

Operating profitability

Operating profit = profit from firm's core business operations.

A target for operating profitability. For example, management might set targets for:

- Profit/sales ratio (say, a minimum of 20%); or
- Gross profit percentage (say a minimum of 40%); or
- Return on capital employed (say, a minimum ROCE of 20%).

Hitting these ratios should increase the chance of making good overall net profits.

Q4 June 2013 (extract)

A company is considering raising $3,200,000 by issuing bonds paying annual interest of 6%. Funds raised would earn 18% before tax. Recent results were:

	$'000
Operating profit	3,450
Interest	200
Profit before tax	3,250
Tax @ 20%	650
Profit after tax	2,600
Dividends	1,600
Retained	1,000
Ordinary $0.50 shares	5,000

Required: Calculate the effect on earnings per share and interest cover of the proposal to raise finance by issuing new debt and comment on your findings. (5 marks)

Q4 June 2013 (extract) – Answer (1)

In order to answer this question, calculate revised operating profit, interest, profit before tax and profit after tax.

This is to get the earnings figure so that a revised EPS can be calculated and compared to the current figure, which also needs to be calculated.

Similarly a revised interest coverage calculation can be made.

Q4 June 2013 (extract) – Answer (2)

Revised operating profit = (0.18 × 3.2m) + 3,450,000 = $4,026,000

Revised interest = (3,200,000 × 0.06) + 200,000 = $392,000

Revised profit before tax = 4,026,000 – 392,000 = $3,634,000

Revised profit after tax = 3,634,000 × (1-0.2) = $2,907,200

Current EPS = 100 × 2,600/10,000 = 26.0 cents per share

Revised EPS = 100 × (2,907,200/10,000,000) = 29.1 cents per share

Earnings per share would increase by 3.1 cents per share.

Current interest cover = 3,450,000/200,000 = 17 times

Revised interest cover = 4,026,000/392,000 = 10 times

Q4 June 2013 (extract) – Answer (3)

The increase in earnings per share would be welcomed by shareholders, but further information on the future of the company following the investment in research and development would be needed for a more comprehensive answer.

The decrease in interest cover may well be acceptable given the higher returns.

Non-financial targets

Non-financial targets are sometimes adopted by, or imposed on management. Examples are:

- Minimum targets for recycling waste
- Quality standards
- Fair treatment of suppliers
- Negative externalities (such as the release of greenhouse gasses)

If these targets are imposed by law, companies must comply or there will be penalties.

Some targets are voluntarily adopted because they will help the long term reputation of the company.

Stakeholders

Stakeholders are individuals or groups who are affected by the activities of the firm.

They can be classified as:

- **I**nternal (employees, directors and managers)
- **C**onnected (shareholders, customers and suppliers)
- **E**xternal (local communities, pressure groups, government)

They are important because they can prevent an organisation achieving its objectives.

Question to consider

How could the following stakeholders prevent or interfere with the achievement of an organisation's objectives?

- Employees
- Customers
- Suppliers
- Government
- Shareholders

Answer

Stakeholder	Power
Employees	Strikes; non-cooperation; sabotage
Customers	Take business elsewhere
Suppliers	Refuse to sell on credit
Government	Change laws and regulations (note, government can also be an important customer)
Shareholders	Vote the directors off the board if they do not like policies and performance

Stakeholders

Usually, different sets of stakeholders have different objectives and often these are in conflict. For example:

Stakeholder group		Stakeholder group
Shareholders want higher profits	Conflicts with	Employees want higher wages
Customers want higher quality and lower prices	Conflicts with	Managers and shareholders want higher profits
Local people want little disruption to their lives	Conflicts with	Management wants 24-hour operations at a factory or airport

Management has to balance stakeholders' objectives and their power to try to keep most happy most of the time.

Management and shareholders

Shareholders own the company, but managers run it.

Shareholders are the *principals*, managers are their *agents.* Agents should work in the best interests of their principals – but might not! This is known as 'the agency problem'.

Managers are monitored and controlled through:

- Financial statements
- Auditors
- The annual general meeting
- Removal by shareholders
- Corporate governance regulations

All of these cost money, known collectively as 'agency costs'.

Question to consider

Governments can have profound effects on companies.

Make a list of about six influences governments can have on companies.

Answer

Government's effects on companies include

1. Taxation
2. Encouraging investment (for example, grants)
3. Regulations (for example, on emission of waste products or employee protection)
4. Provision of infrastructure (such as roads/railways)
5. Economic policy (interest rates, money supply, exchange rates)
6. Government spending
7. Import restrictions and tariffs
8. Educational policy

Financial performance measurement

- To establish financial control in an organisation, it is necessary to measure its progress so that managers know how well it is doing.

- *Ratio analysis* is often used.

- In ratio analysis comparisons are made between financial variables, such as those in the statement of financial position and those in the statement of profit or loss.

Financial performance measurement: ratios

Ratios fall into four categories:

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

Do not use them indiscriminately: focus on what the question is interested in you evaluating and choose appropriate ratios.

Profitability and return ratios (1)

Return on capital employed

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

Capital employed = Shareholders' funds plus long-term liabilities

= Total assets less current liabilities.

Profitability and return ratios (2)

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 and calculated in the same way

(c) A comparison of the ROCE with current market borrowing rates to assess:

   (i) Are profits high enough to make borrowing worthwhile?

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

Profitability and return ratios (3)

ROCE can be broken down into:

ROCE = Profit margin × Asset turnover

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

Breaking it down may help explain why it is changing
eg if improving, higher margin or better turnover per $1 capital.

Profitability and return ratios (4)

Return on equity

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

This 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. However, it could also imply high debt finance (gearing) with associated higher risk.

Profitability and return ratios (5)

Gross margin and net margin

$$\text{Gross margin} = \frac{\text{Gross profit}}{\text{Sales}}$$

$$\text{Net margin} = \frac{\text{Net profit}}{\text{Sales}}$$

Gross margin can be a key performance indicator for certain businesses eg retail.

If the gross margin is high but net margin is weak, this might imply that expenses are out of control.

Liquidity ratios

Current ratio and quick (acid test ratio)

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liabilities}}$$

or

$$\text{Quick ratio} = \frac{\text{Current assets except inventory}}{\text{Current liabilities}}$$

If too low, the company will have trouble paying its liabilities as they fall due. (Covered fully in Chapter 4.)

If too high, may indicate poor management (eg excess inventory).

Debt and gearing ratios

Financial gearing ratio

$$\text{Gearing ratio} = \frac{\text{Long term debt}}{\text{Equity}}$$

or

$$\text{Gearing ratio} = \frac{\text{Long term debt}}{\text{Debt + equity}}$$

High gearing implies a higher risk that the company will default on interest or loan payments. (Covered more fully in Chapter 14.)

Shareholders' investment ratios

Dividend yield

$$\text{Dividend yield} = \frac{\text{Dividend per share}}{\text{Ex-dividend market price per share}}$$

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

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

Earnings per share

Earnings per share (EPS)

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

This was discussed earlier: good earnings are essential for a successful future.

Price earnings ratio (P/E ratio)

Price earnings ratio

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

The value of the P/E ratio reflects the market's appraisal of the share's future prospects. It measures how many years' worth of future earnings are represented by the share price.

A high P/E implies a positive outlook – shareholders are paying a high price for the shares.

Managerial reward schemes (1)

Earlier we mentioned the agency relationship: shareholders own the company, managers and directors run it.

- It is therefore important to align managerial action to shareholders' wish to maximise their wealth. This achieves *goal congruence.*
- Suitable managerial reward schemes can encourage goal congruence so that managers act in the interests of shareholders.

Managerial reward schemes (2)

Performance-related pay

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

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.

Executive share options plans (ESOPs)

Employees are awarded share options giving the right to subscribe for shares in the company at a fixed price. The value of an option will increase if the share price goes up.

Employee reward schemes: Rolls Royce (1)

Here is an extract form the Rolls Royce 2012 annual report:

All employees worldwide have the opportunity to benefit from our success through participation in our global bonus and share plans.

All employees who were with us throughout 2012 will be receiving a bonus of at least two weeks' pay as a result of our 2012 performance. Around a half of our employees currently participate in our global save-as-you-earn ShareSave plan which gives all employees the opportunity to benefit from share price growth.

Employee reward schemes: Rolls Royce (2)

In February 2013, two of our ShareSave plans matured – a three-year plan granted in 2009 at an option price of 387 pence and a five-year plan granted in 2007 at an option price of 416.1 pence against a closing price on 1 February 2013 of 971 pence.

Benefits of linking rewards and performance

- Gives individuals an incentive to achieve a good performance level
- Effective schemes help to attract and keep the employees valuable to an organisation
- It is clear to all employees how performance creates organisational success
- Focuses on continuous improvement
- Schemes based on shares can motivate employees and managers to act in the long-term interests of the company by doing things to increase the organisation's market value

Problems with incentive schemes (1)

- Dysfunctional behaviour – for example, padding budgets to make subsequent variances more favourable
- Making decisions that are bad for the organisation but which increase managers' remuneration
- Schemes designed to ensure long-term achievements might not motivate since efforts and reward are too distant in time from each other
- Employees concentrate on what is measured, rather than the objectives of the organisation

Problems with incentive schemes (2)

- Personal performance may be encouraged at the expense of team work.
- High levels of output may be achieved at the expense of quality.
- To make bonuses accessible, standards and targets may have to be lowered.
- They undervalue intrinsic rewards compared to extrinsic rewards.

Q1 December 2008

At a recent board meeting of Dartig Co, a non-executive director suggested that the company's remuneration committee should consider scrapping the company's current share option scheme, since executive directors could be rewarded by the scheme even when they did not perform well. A second non-executive director disagreed, saying the problem was that even when directors acted in ways which decreased the agency problem, they might not be rewarded by the share option scheme if the stock market were in decline.

Required:

Explain the nature of the agency problem and discuss the use of share option schemes as a way of reducing the agency problem in a stock-market listed company such as Dartig Co. (8 marks)

Q1 December 2008 – outline answer (1)

To answer this question it will be necessary to define the agency problem and explain its significance. Do not neglect the second part of the requirement which discusses the use of share option schemes as a way of mitigating the risk caused by the agency problem.

Note that the question specifies listed companies, where the agency problem is likely to be greater due to ‘distanced’ relationships between owners and directors.

Q1 December 2008 – outline answer (2)

The primary financial management objective of a company is usually taken to be the maximisation of shareholder wealth – usually assumed to be the maximisation of share price.

In practice, the managers of a company acting as agents for the principals (the shareholders) may act in ways which do not lead to shareholder wealth maximisation as they pursue potentially incompatible personal goals. This is the agency problem.

Share options (rights to buy shares on a future date at a fixed price) is one way to encourage managers to act in ways that increase shareholder wealth.

Q1 December 2008 – outline answer (3)

Share options will encourage managers to make decisions likely to lead to share price increases as this will increase the capital gain that could be made by managers.

However, it is possible that managers may be rewarded for poor performance if share prices in general are increasing.

It is also possible that managers may not be rewarded for good performance if share prices in general are falling.

It is difficult to decide on a share option exercise price and exercise date that will encourage managers to focus on increasing shareholder wealth while still remaining challenging, rather than being easily achievable.

Corporate governance – main provisions

Corporate governance is the system by which organisations are directed and controlled. Outline knowledge needed for F9.

- The management and reduction of risk is fundamental.
- Performance is improved by good organisational structures, management and accountability.
- Good governance provides a framework for an organisation to pursue its strategy in an ethical and effective way.
- Good governance requires a willingness to apply the spirit as well as the letter of the law.

Corporate governance – good practice (1)

- The board should be responsible for taking major policy and strategic decisions.
- Directors' performance should be assessed regularly.
- Division of responsibilities between the chairman and chief executive.
- Independent non-executive directors (NEDs) must be appointed. Their number and status should mean that their views carry significant weight.
- Directors' remuneration should be set by a remuneration committee consisting of NEDs.
- Most countries have regulatory code which must be followed on a ‘comply or explain’ basis for listed firms.

Corporate governance – good practice (2)

- Appointments should be administered by a nomination committee (NEDs).
- Boards should regularly review risk management and internal control.
- Audit committees of independent NEDs should liaise with external audit and supervise internal audit.
- The board should maintain a regular dialogue with shareholders.

Not for profit organisations

Not-for-profit and public sector organisations have their own objectives, generally concerned with achieving specified objectives effectively and efficiently – value for money ‘VFM’.

The 3Es approach can be a great help:

- **Economy** is attaining the appropriate quantity and quality of inputs at lowest cost to achieve a certain level of outputs
- **Efficiency** is the relationship between inputs and outputs.
- **Effectiveness** is the extent to which declared objectives/goals are met.

Not for profit organisations – some measures

- Surplus maximisation (equivalent to profit maximisation)
- Revenue maximisation (as for a commercial business)
- Usage maximisation (eg a public library)
- Usage targeting (eg appointments available = demand)
- Full/partial cost recovery (minimising subsidy)
- Budget maximisation (maximising what is offered)
- Client satisfaction maximisation (a charity generating support from its beneficiaries)

Not for profit organisations – problems

- Many objectives and stakeholders.

  For example, how does a health service divide its efforts between heart patients, cancer patients and accident and emergency patients?

- Difficulty in measuring outputs.

  For example, in a health service what is the value of giving one person one more month of life compared to giving 100 people their sight?

Q4 December 2011 (extract)

Compare and contrast the financial objectives of a stock exchange listed company such as Bar Co and the financial objectives of a not-for-profit organisation such as a large charity. (11 marks)

Q4 December 2011 (extract) – outline answer (1)

The question here asks you to compare and contrast.

This requires a comparison of the different types of financial objectives not just two separate lists of objectives.

Don't forget to include areas of similarity in objectives of the two types of organisation not just the differences.

Q4 December 2011 (extract) – outline answer (2)

A key financial objective for a listed company is to maximise the wealth of shareholders, usually assumed to be met by maximising the company's share price.

Not-for-profit (NFP) organisations seek to provide services to the public. A large charity seeks to raise as much cash as possible to do this.

Both companies and charities have to control costs.

NFPs look at value for money (VFM). This objective focuses on economy, efficiency and effectiveness.

A listed company also seeks to achieve value for money in its business operations.

Q4 December 2011 (extract) – outline answer (3)

However, a listed company has a profit motive, and so VFM for a listed company can be related to performance measures linked to output.

An NFP organisation has service-related outputs that are difficult to measure in quantitative terms and so may focus on performance measures linked to input, eg minimising the input cost for a given level of output.

Both listed companies and NFPs can use a variety of accounting ratios in the context of financial objectives. For example, both types of organisation may use a target return on capital employed, or a target level of income per employee, or a target current ratio.

Recent exam questions

Nature of question	Exam details
Financial objectives and corporate strategy	June 2013 Q1(c) June 2009 Q4 (a)
Shareholder wealth maximisation	December 2013 Q1 (c) June 2010 Q4 (c)
Earnings per share	Pilot Q1 (c) June 2009 Q4 (a) June 2013 Q4 (b) (c)
Measuring financial performance	December 2009 Q4 (d) June 2011 Q3
Agency problem	December 2008 Q1 (e)