SECTION A

ROLE AND RESPONSIBILITY TOWARDS STAKEHOLDERS

A1

STUDY GUIDE A1: THE ROLE AND RESPONSIBILITY OF SENIOR FINANCIAL EXECUTIVE / ADVISOR

Get Through Intro

The finance director of yesteryear was predominantly responsible for the production of financial statements and checking actual figures to budgeted figures. But what does a modern senior financial executive do? How have his roles and responsibilities changed? More importantly, what will you be asked to do in the future? A financial executive has now changed from an accountant into a business strategist, responsible for many areas way beyond the preparation of financial statements. As a business strategist, he is responsible for giving options for raising funds, strategy and future direction amongst other tasks.

This Study Guide explains what the main roles of a senior finance professional are and why their role is so important. It is a significant Study Guide for you to understand as remember; you will be doing all of this one day soon!

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Learning Outcomes

a) Develop strategies for the achievement of the firm's goals in line with its agreed policy framework.
b) Recommend strategies for the management of the financial resources of the firm such that they are utilised in an efficient, effective and transparent way.
c) Advise the board of directors of the firm in setting the financial goals of the business and in its financial policy development with particular reference to:
   i. investment selection and capital resource allocation
   ii. minimising the firm's cost of capital
   iii. distribution and retention policy
   iv. communicating financial policy and corporate goals to internal and external stakeholders
   v. financial planning and control
   vi. the management of risk.

Case Study

Enron is a name that accountants will not forget in a hurry. Enron once had pride of place in the top 10 largest companies in America. However, it became bankrupt when it came to light that a number of accounting irregularities had occurred, which effectively showed a company with billions of losses as a profitable venture.

The CFO, Andrew Falstaff was sentenced to 6 years in prison, although he had initially been indicted on over 70 counts. The counts included money laundering and insider trading. His sentence was reduced as he became an informant about other activities within Enron.

This case study shows that as a senior financial person in a company, you will be held responsible for the actions of your company and you must behave ethically. It is not enough to say that you were unaware of illegal activities. If you have doubts at any point, you must remain ethical and make ethical decisions. A lot of people are relying on you!

1. Develop strategies for the achievement of the firm's goals in line with its agreed policy framework. [3]

[Learning Outcome a]

1.1. What is strategy?

Strategy is the **direction** and **scope** of an organisation over the **long term.** The strategy achieves an **advantage** for the organisation through its configuration of **resources** within a challenging **environment**, to meet the needs of **markets** and to fulfil **stakeholder** expectations.

Example

Strategy is a term that refers to a complex web of thoughts, ideas, insights, experiences, goals, expertise, memories, perceptions and expectations that provides general guidance for specific actions in pursuit of particular ends.

The many definitions of strategy found in management literature fall into one of four categories. These are plan, pattern, position and perspective. According to these views, strategy is:

- a plan, a "how," a means of getting from here to there
- a pattern in actions over time (for example, a company that regularly markets very expensive products is using a "high end" strategy)
- a position (i.e. it reflects decisions to offer particular products or services in particular markets)
- a perspective (i.e. a vision and direction, a view of what the company or organisation is to become)

Example

Software Solution's principal objective is to be the number one supplier globally in terms of their product sales. They believe that such sector leadership, delivered by strong sales and profitability is the best way for a software business to deliver maximum shareholder value. They were recently ranked number three against these criteria, having risen steadily in this ranking.

It believes that this is the most realistic strategic objective, partly because of the strength and depth of its product portfolio, and also because it currently competes against a group of vendors that have substantial business scale in areas where it has not traditionally been active, such as system integration services or non product-related outsourcing. It should be noted that product sales is the primary driver for its other revenue streams, professional services and recurring income. It intends to continue working towards this objective through a number of well-established strategic approaches:

- continuing growth of market share in their core product lines through their traditionally strong sales and marketing focus.
- cross-selling of additional products to their existing 400-plus customers, the majority of whom have only one or two of its products.
- expansion within these core product lines by developing and commercialising additional solution offers that expand its potential customer base.
- diversification into non-telecom markets where its product strengths have proven application, such as financial services.
- addition of new product capabilities, by acquisition or internal development that it can sell to new and existing customers.

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Test Yourself 1

Define strategy and describe its relationship with tactics.

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2. Recommend strategies for the management of the financial resources of the firm such that they are utilised in an efficient, effective and transparent way.[3]

[Learning Outcome b]

2.1. Financial resources

Financial resources are those resources that give a business the means to "finance" its chosen strategy.

Example

A strategy that requires significant investment in new products, distribution channels, production capacity and working capital will place a great strain on the business finances. Such a strategy needs to be very carefully managed from a finance point-of-view.

Corporate finance is concerned with the effective and efficient management of the finances of an organisation in order to achieve the objectives of that organisation. This involves planning and controlling the provision of resources (from which funds are raised), the allocation of resources (where funds are deployed) and finally the control of resources (whether funds are being used effectively or not). The fundamental aim of financial resources is the optimal allocation of the scarce resources available to them – the scarce resources being money.

1. Relationship between risk and return

Management of financial resources is part of overall financial strategy and financial managers require to think about the desired **balance between risk and return.** A company takes on more risk only if a higher return is offered in compensation. Return refers to the financial rewards gained as a result of making an investment. The nature of the return depends on the form of the investment. A company that invests in fixed assets and business operations expects returns in the form of profit and in the form of increased cash flows.

The meaning of risk is more complex than the meaning of return. A company expects or anticipates a particular return when making an investment. Risk refers to the possibility that the actual return may be different from the expected return. The actual return may be greater than the expected return, which is usually a welcome occurrence. Investors, companies and financial managers, however, are more likely to be concerned with the possibility of the actual return being less than the expected return.

A risky investment is therefore one where there is a significant possibility of its actual return being different from its expected return.

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Example

Black Ltd invested funds in the shares of a multinational company. As the possibility of the actual return being different from the expected return increased due to the perceived riskiness of the investment, investors demanded a higher expected return. Black Ltd therefore expected a higher rate of return to compensate for the higher level of risk.

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2. Time value of money

The time value of money is a key concept in corporate finance. It is particularly important to companies, however, since the financing, investment and dividend decisions made by companies result in substantial cash flows over a variety of periods of time. Simply stated, the time value of money refers to the fact that the value of money changes over time.

3. Value for money

Value for money generally signifies the following three elements relating to the internal operations of the organisation and its use of money.

- Economy
- Efficiency
- Effectiveness

a) **Economy** is concerned with minimising the cost of resources acquired or used, while maintaining appropriate quality.
b) **Efficiency** is concerned with the relationship between the resources (input) and the output of goods, services or other results. Ideally, minimum input should be used for a given output and maximum output should be achieved for a given input.
c) **Effectiveness** is concerned with the relationship between the planned results and the actual results of projects, programmes or other activities. To what extent do the outputs of goods and services or other results successfully achieve policy objectives, operational goals and other planned effects?

Test Yourself 2

Briefly explain the difference between short-term and long-term financial strategies.

3. Advise the board of directors of the firm in setting the financial goals of the business and in its financial policy development [2] with particular reference to:

i. investment selection and capital resource allocation
ii. minimising the firm's cost of capital
iii. distribution and retention policy
iv. communicating financial policy and corporate goals to internal and external stakeholders
v. financial planning and control
vi. the management of risk.

[Learning Outcome c]

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Before we discuss the objectives of the financial manager, we need to understand who the financial manager is and what his other primary objectives are.

3.1 The role of financial manager

Who is the financial manager?

The term **financial manager** refers to anyone responsible for a significant investment or financing decision. It is only in the smallest firm that a single person is responsible for all the decisions. In most other cases, the decision making responsibility is dispersed.

Nevertheless, there are some managers who specialise in finance.

Role	Function
Treasurer	Responsible for looking after a firm's cash, raising new capital, and maintaining relationships with banks, shareholders and other investors.
Controller	Prepares the financial statements, manages the company's internal accounting and looks after its tax obligations.
Financial director	Oversees both the treasurer's and the controller's work. The financial director is involved in setting up the financial policy and planning corporate strategy.

Due to the importance of many financial issues, the ultimate decisions often rest, by law or by custom, with the **board of directors.**

Primary financial objectives of the financial managers

The primary objective of corporate finance is to make decisions that maximise the value of the company for its owners. As the owners of the company are its shareholders, the primary financial objective of corporate finance is the **maximisation of shareholder wealth.** Since shareholders receive their wealth through dividends and capital gains (increases in the value of their shares), shareholder wealth will be maximised by maximising the value of dividends and capital gains that shareholders receive over time.

How is shareholder wealth maximised?

Shareholders' wealth is increased through the cash they receive in dividend payments and the capital gains arising from an increased share price. It follows that shareholder wealth can be maximised by maximising the purchasing power that shareholders derive through dividend payments and capital gains over time.

The indicator of shareholders' wealth is a company's ordinary share price, since this reflects expectations about future dividend payments as well as investors' views about the long-term prospects of the company and its expected cash flows. Therefor e, the surrogate objective is to maximise the current market price of the company's ordinary shares and hence maximise the market value of the company.

The price of a company's shares will go up when the company makes attractive profits, which it can either pay out as dividends now or re-invest in the business to achieve future growth of both profit and dividend.

SUMMARY

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Test Yourself 3

What are the fundamental problems associated with profit maximisation as an overall goal of a company?

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1. Investment decisions

Investment decisions relate to the selection of assets in which funds will be invested by a firm. The assets which can be acquired fall into two broad groups:

- long-term assets which will yield a return over a period of time in the future
- short-term or current assets which, in the normal course of business, are convertible into cash without diminution in value, usually within a year

Example

George is the financial manager of Dream Ltd. He must decide the best mix of current assets and fixed assets to be held by the company to pursue its chosen strategy. He needs to determine and maintain certain optimal levels of each type of current asset. He should also decide the best fixed assets to acquire and when existing fixed assets need to be modified or replaced. The success of Dream Ltd to a large extent will depend upon these decisions.

Financial managers are responsible for a company's investment decisions, advising on the allocation of funds in terms of the total amount of assets, the composition of fixed and current assets and the consequent risk profile of the choices.

They are also responsible for raising funds, choosing from a wide range of institutions and markets, with each source of financing having different features in terms of cost availability, maturity and risk. The places where supply of finance meets demand for finance are called the **financial markets. T**hese consist of the **short-term money markets** and the **longer-term capital markets**.

A major source of finance for a company is internal rather than external, i.e. retention of part of the earnings generated by its business activities. The managers of the company, however, have to strike a balance between the amount of earnings they retain and the amount they pay out to shareholders as a dividend.

The position of the financial manager as a person central to these decisions and their associated cash flows is shown in diagram 1.