The ExP Group

ACCA FM | ExPress Notes

Financial Management

SBL SBR AFM APM ATX AAA

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Contents

Steve Crossman
CEO The ExP Group

Hello

Thank you for downloading a copy of these ExPress notes and I hope you find them useful for your studies.

We provide these ExPress notes free of charge to individual students as part of our CSR initiatives. The notes are designed to help students assimilate and understand the most important areas for the exam as quickly as possible.

A word of warning though in that they have not been designed to cover everything in the syllabus so you should only use these notes for either an overview of the key areas before you start your main studies or as part of your final revision in the run up to your exams.

Importantly though, we want you to be successful in your exams so good luck with your studies and please do let us know how you get on.

All the best,

Steve

About The ExP Group

We were born with one passion, with one aim, with one desire. To use technology the way it should be used. To use technology to open up education, and in particular financial education, to whoever needs it regardless of their income, wealth, race, sex, religion or location.

We wanted to use technology to empower individuals to develop themselves through financial expertise, organisations to improve their performance through enhanced human capital and ultimately communities and families to benefit as a result.

We're on target and since our birth we have had the privilege of working with and learning from inspirational individuals and organisations from all 4 corners of the world in countries as varied as the UK in the north, Singapore in the east, South Africa in the south and the Cayman Islands in the west.

We're only part way through our journey but we're doing better than we expected. The best is yet to come though,

Education + Technology = Ethical Empowerment.

Thank you for being part of our story.

01 Financial Management Function

Key Knowledge – The Nature and Purpose of Financial Management

The main purpose of financial strategy is to ensure that financial resources are available to the organization in support of its overall corporate objectives, which include financial objectives.

Management accounting is a set of tools and disciplines measuring corporate performance and to facilitate decision-making; it is designed and implemented in coordination with the company's strategy.

Financial accounting is concerned with maintaining the records of the transactions of the firm and preparing financial statements for the benefit of shareholders (and other external audiences) in conformity with established accounting standards.

Key Knowledge – Financial Objectives and the Relationship with Corporate Strategy

In pursuing its financial objectives, the firm must ensure that those objectives are congruent – i.e. consistent – with its overall corporate strategy.

Key Knowledge – Stakeholders and Impact on Corporate Objectives

Stakeholder groups

- Shareholders: As owners of the business, they rank supreme, as reflected in US/UK models of corporate governance;

- Lenders: Important if the business relies heavily on providers of loan capital (banks, bondholders);
- Directors: The executive directors or senior management of the business are central since they have "hands-on" power and can serve their own interests (giving rise to agency risk);
- Employees: Often referred to as a company's "most valuable asset"; they must be motivated and adequately compensated;
- Customers: No customers, no business! How influential they are or how carefully management needs to listen to their concerns depends on the type of business activity and the competitive environment;
- Suppliers: Good and reliable suppliers can be critical to corporate success;
- Government: They have two major interests: (a) they receive revenue via taxes and (b) benefit indirectly when firms create employment. Environmental and other regulatory concerns are also within the scope of the government's interest;
- Public: The general public, its opinions and ability to exert pressure through lobby groups are all relevant factor for businesses that pollute, are involved in nuclear power, or carry out other activities that may be controversial (e.g. abortion clinics).

Conflicting stakeholder interests

Conflicting interests can exist between various stakeholder groups.

Management must examine the degrees of stakeholder influence and actively manage the relationship with relevant stakeholders.

Agency theory

Agency theory addresses the risk that management will not act in the best interest of the shareholders, but will make decisions that will serve its own interests.

Examples of self-serving management behavior could include: (a) artificially boosting corporate profits in the short-term in order to earn bonuses; (b) paying too much to acquire another company for reasons of prestige or in order to "build empires"; (c) rejecting opportunities, such as takeover bids, or restructuring initiatives, that might jeopardize their positions (an orientation to maintaining the "status quo").

Influencing managerial behavior

In order to cause managers to behave in a way consistent with stakeholder interests, rewards and bonus schemes need to be carefully designed. This can be seen as the "internal" dimension to corporate governance. The other dimension -- "external" – comes in the form of regulation.

Scope of strategic performance measures in private sector

Shareholder value measurements focus on creation of shareholder value as fundamental aim of profit oriented companies.

Long-term wealth maximization is not always consistent with the "artificial" inflation of profits in the short-term. If a company stops investing, for example, it can boost its short-term profitability, but this may come at the expense of the company's medium- to long-term competitiveness.

The following are some of the financial measures typically used by companies to measure performance.

Return on Investment (ROI/ROCE)

(Accounting PBIT / Accounting Capital Employed) * 100%

Accounting Capital Employed = Total Assets – Current Liabilities = Total Non-Current Assets, net + Working Capital

Disadvantage: ROI/ROCE increases as investment centre's fixed assets grow older, thus a ROI improvement over time (or a better ROI compared to another division) may be partly attributable to the age of the assets used.

Consequently, gross value of fixed assets may be used in measuring performance based on ROI.

Earnings Per Share (EPS)

Net income less any preferred dividends divided by the number of shares outstanding.

Return on Equity

Net income divided by shareholders' equity.

Key Knowledge – Financial and Other Objectives in Non-for-Profit Organisations

Profit and Not-for-profit organisations

Profit-seeking organizations exist ultimately to create wealth for their owners.

Non-profit (or not-for-profit) organizations are created to accomplish a pre-defined mission, such as the delivery of a service; they are expected to do so in an economical manner.

02 Financial Management Environment

The Big Picture

The economic environment for business

The general economic environment, and in particular the influence of governments – through its monetary and fiscal policies – has a far-reaching impact on most businesses.

Key Knowledge – The impact of macro-economics

Businesses must also take macro-economic factors into account:

- Projected level of market demand for goods and services in the economy;
- In a recovery phase, how government policies are likely to be adjusted with respect to:

    (a) Monetary policy: Effect on interest rates, exchange rates and inflation, (the latter may eventually increase with economic recovery);

    (b) Labour policy: If labour markets tighten, how fast will restrictions (imposed on foreign labor, for example) be relaxed?

    (c) Fiscal policy: Tax increases (both personal and corporate);

    (d) Trade policy: to what degree is any protectionism likely to stay in place?

Again, actively keeping up with reading on these issues will be the best way to prepare for this section of the exam.

Key Knowledge – The nature and role of financial markets and institutions

Financial markets and institutions have achieved such a degree of global integration that shocks in one part can have systematic implications across all markets.

Stock markets

A stock exchange is an organized and regulated market place which permits:

(i) Companies to raise capital through issuing new shares or debentures (collectively known as securities); the proceeds of such issues go to the company issuing them - this is called the "primary market"; and

(ii) Investors to buy and sell already-issued securities - called the "secondary market".

How stock markets operate

The operation of a stock market is accomplished through an auction system where prices are publicly posted after trades are executed; two-way prices are provided (i.e. quoting buy and sell prices), thus ensuring liquidity to the market.

03 Working Capital Management

Key Knowledge – The nature, elements and importance of working capital

This is a core function of management which has day-to-day implications.

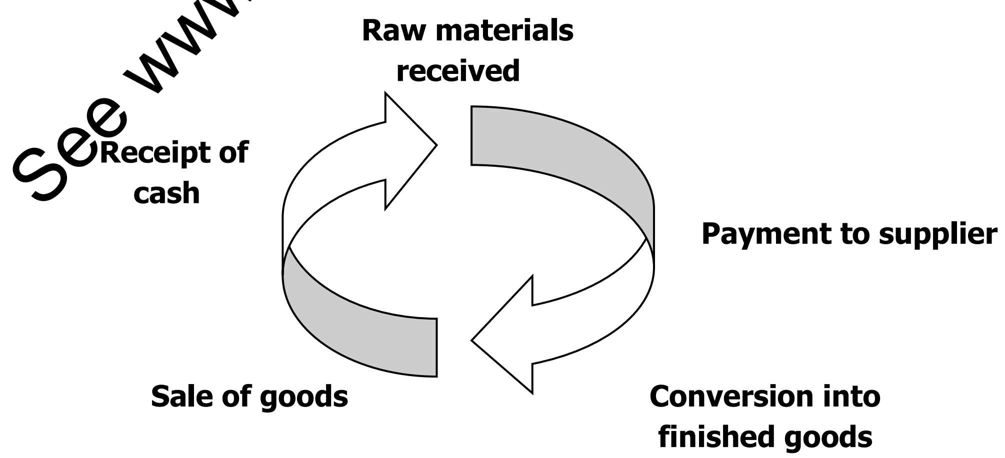
Working capital definition: Current assets – Current liabilities

This is an accounting definition. The discussion and analysis of working capital management focuses on the "operating" elements of current assets and liabilities:

- Cash
- Inventory
- Receivables
- Payables

Key Knowledge – Management of inventories, accounts receivables, accounts payable and cash

These elements are linked through the Cash conversion cycle, also known as the Cash Operating Cycle.



The above diagram shows the operating cash flows for a typical manufacturing company converting raw materials into finished goods for sale. The company needs its own cash to pay the supplier and can only recover this from the sale of the finished goods.

The cash invested in inventories and receivables represents a cost to the company. This is most directly obvious in opportunity cost terms: the cash could be earning interest, reducing interest-bearing debt, or ultimately find its way into shareholders' pockets as a dividend payment.

The presence of payables indicates that cash payments (outflows) are delayed; this is beneficial to the company as long as it is not overdue on its payments, as late payment could lead to penalties or damage to the company's reputation (creditworthiness).

Managing the individual parts of working capital means managing the "whole picture" in an optimal way; doing this well can give a firm a significant competitive advantage over its competitors.

Key Knowledge – Ratio Analysis

Liquidity ratios

The relationship between current assets and current liabilities is used as a measure of liquidity in the firm:

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

$$\text{Quick ratio} = \frac{\text{Current assets} - \text{Inventories}}{\text{Current liabilities}}$$

Turnover ratios

(1) Trade debtors (receivables)

$$\frac{\text{Trade Debtors}}{\text{Sales}} \times 365$$

(2) Inventory turnover

$$\frac{\text{Inventory}}{\text{COGS}} \times 365$$

(3) Trade creditors (payables)

$$\frac{\text{Trade Payables}}{\text{COGS}} \times 365$$

Key Knowledge – Economic Order Quantity (EOQ)

Within a company, there is a natural temptation to accumulate buffer stocks (raw materials and semi-finished goods) so that production is never interrupted.

Similarly, in order to avoid stock-outs, sales managers will insist on maintaining a plentiful level of finished goods. All of this costs money.

The EOQ is a method which seeks to minimize the costs associated with holding inventory.

To determine the total costs, the following data is required:

Q = order quantity

D = quantity of product demanded annually

P = purchase cost for one unit

C = fixed cost per order (not incl. the purchase price)

H = cost of holding one unit for one year

The total cost function is as follows:

Total cost = Purchase cost + Ordering cost + Holding cost

which can be expressed algebraically as follows:

TC = P x D + C x D/Q + H x Q/2

It is this total cost function which must be minimized.

Recognising that:

- PD does not vary;
- Ordering costs rise the more frequently one places (during the year); and
- Holding costs rise the fewer times one places orders (due to larger quantities being ordered each time),

It follows that there is a trade-off between the Ordering and the Holding costs.

The optimal order quantity (Q*) is found where the Ordering and Holding costs equal each other, i.e.

C x D/Q = H x Q/2

Rearranging the above and solving for Q results in

$$Q^* = \sqrt{\frac{2CD}{H}}$$

Key Knowledge – Assessing the creditworthiness of customers

When assessing the creditworthiness of (potential) clients, companies can use the approach typically employed by banks, referred to (originally) as the 3 C's of credit, later expanded to the 5 C's. They are

(1) Character: Focuses on the reputation of the principals/decision makers at a company; credit checking agencies and bank references assist to this end;

(2) Capacity: Examines the company's cash flow generation in the context of management's ability to perform competently and reliably in meeting their obligations, based on an examination of their track record (either directly or via the experiences of others). Financial statement analysis is a major part of the exercise here (and in the next point);

(3) Capital: Identifies and assesses the financial "staying power" and resources of the business; how much of a capital cushion do they have to withstand losses and how much do they have committed at risk in a proposed transaction that incentivizes them to succeed (one can refer to this as the "pain factor");

(4) Collateral: Assesses what (if any) security the company is willing to provide in support of the intended transaction. Banks refer to this as providing additional exits ("ways out") from a transaction.

(5) Conditions: This is a general review of the economic environment to appreciate to what extent a customer may be affected by a decline in general business conditions (business cycle influences).

Example

A downturn in housing construction will affect a range of other businesses, from plumbers to building material producers and companies leasing earth-moving equipment. Anyone selling to such businesses needs to keep the "big picture" in mind so as not to be over-exposed to secondary influences.

Settlement discounts

The objective of granting a settlement discount is to give customers a financial incentive to pay their bills more quickly (before the standard due date).

A company granting settlement discounts must ensure that the benefits of doing so will outweigh the costs.