Financial Goal of a Firm

Why do firms/business exist?

Business firms exist to satisfy the human needs that the Governments are neither able or willing to provide. E.g. food, clothing, drinks and beverages, transport and production and equipment.

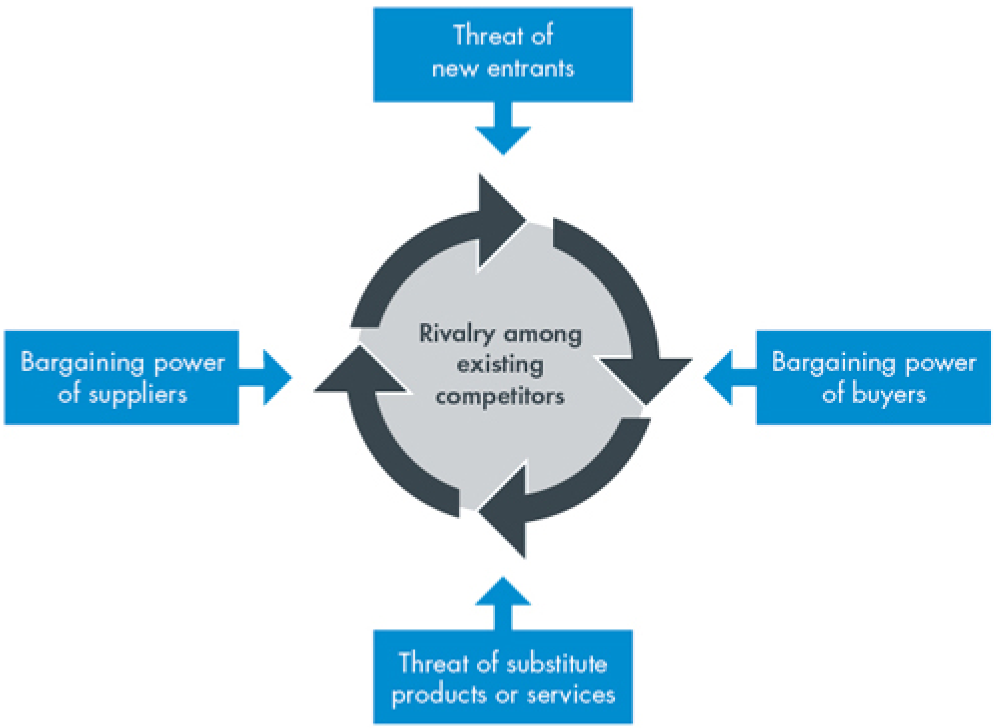
Each business is governed by its mission statement. The mission statement details what the business does i.e. its core business.

Business Environment

Business operate in a competitive environment and for a business to succeed, it must have a strategy/ies to keep it no business. The firm must remain focussed on its core business.

According to Porter there are five forces in the business operating environment. Porter's competitive 5 forces model outlines the following forces:

a) Threat of new entrants
b) Bargaining power of clients
c) Bargaining power of suppliers
d) Threat of technology
e) Rivalry within an Industry



Strategies that Businesses may use:

a) **Cost Leadership** – produce goods a lower cost than competitors and pass on the cost benefit to the customers by lowering the selling price. This works well for business that push high volumes.
b) **Differentiation** – providing unique goods and/or services to customers with value for money.
c) Focus Strategy – identify a small group of customers in the market that you service and target their unique needs. This also known as niche marketing.

What is financial management?

Financial Management is concerned with 3 fundamental questions that business owners have to answer:

a) What long term investments should a business take?
b) Where will the funding come from? Source of funding
c) How will you manage the working capital i.e the day to day financial activities?

Financial management can therefore be defined as an application of general managerial principles in financial decision making of obtaining funds and effectively utilising it in business.

Financial management entails: Planning
Organising
Controlling
Monitoring

All this done to achieve the firm's objectives.

Forms of Business Organisations
Business organisations can be classified into 3
a) Sole proprietorship
b) Partnership
c) Companies

a) Sole Proprietorship
- One person
- No formalities required
- Losses incurred can be offset against by other incomes

The disadvantage of this is that the owner is fully liable for all the business debts and can use personal assets because there is no separation between the person and the business entity.

b) Partnership
Business is owned by two or more people with a private agreement
- There are no formalities to set up the business. You only need a partnership agreement
- Losses incurred are offset by other income.

Disadvantages: - Business is not separate from individuals
- Partners are liable for the business debts. (partners are joint and severally liable for the partnership debts.

- Partners are liable for income tax on their share of profit

c) **Companies**

These are legal persons brought into existence by complying with the Companies Act. There are two types of companies namely private and public companies.
Public companies are registered with word Limited
Private companies are identified by P/L Proprietary Limited.

Advantages

- Limited liability
- A company is a tax entity.

Disadvantages

- Procedures of registration and operation are more complex and are govern by the Companies Act, Tax Laws, Affirmative Action and Labour Act.

Financial Goal of a Business

The financial goal of a business is to maximise the shareholder's wealth through sound financial decisions. This may be achieved by:

- Investing in assets that add value (prudent)
- Keeping cost of capital as low as possible.

Classes of Investments:

i) Real Estate
ii) Equity- (shares)
iii) Fixed Interest Securities
iv) Cash

Each investment has some inherent risk in it (varies depending circumstances)

Investments are divided into long term and short-term investments

Short term Goals are concerned with:

a) **Profitability** – Ability to generate surplus income
b) **Liquidity** – ability to meet short term obligations as they fall due
c) **Solvency** – refers to how much total assets exceed total liabilities.

Maximising shareholders wealth versus maximising profit.

Wealth maximisation looks into the future (long term) whereas profit maximisation looks into the short term.

Finance

Finance is divide into 2: Financial Accounting versus Financial Management

Financial Accounting

Financial accounting is concerned with developing data that is used to measure the financial performance of the business. This takes into account:

- Guidelines such as International Accounting Standards (IAS), General Accepted Accounting Principles (GAAP)

- Revenues are recognised when the transaction occurs.

Financial accounting is historical. It records the activities that have already taken place.

Financial Management involves:
- managing the liquidity and solvency of a company
- timing of cash inflows and outflows.
- revenues and expenses are recognised when the cash is received or paid out.
- Forward looking.

Financial management provides additional information to the financial statements and analyses figures to make a decision.

Role of the Financial Manager

a) Making investment decisions (cost effective use of assets)
b) Making financing decisions
c) Ensuring profitability
d) Ensuring positive cashflows
e) Ensuring Solvency.

Fundamental Principles of Financial Management

There are 3 basic principles in financial management:

a) **Cost Benefit Principle -** Decisions should be based on the result of analysis of total costs of a resource and the benefit derived therefrom.
b) **Risk Return Principle** – entails evaluating the extent of the risk and the return derived. The greater the risk the higher the required rate of return.
c) **Time Value for Money** – states that the value of an amount of money could be increased by investing it and earning interest on the amount.

Financial Management and the Operating Environment

Businesses operate in a complex competitive environment as discussed under Porter's five forces model. There are additional factors that impact firms' sustainability.

a) Economic environment
b) Regulatory and Political Environment
   Businesses are legal entities and must comply with the legislation such as affirmative action, Income Tax act, VAT Act and Labour Act.
c) Natural environment
   E.g. mining, farming

Agency Problem

Owners of businesses are not always the ones responsible for running of the business. They appoint people who run the business on their behalf in their best interest and create wealth. However, managers do not act in the interest of their masters. They act in their own interests at the expense of their owners.