



# 5.1 Setting financial objectives

## Mrs Bond



# Financial targets

- **Financial target** – a goal or objective to be pursued by the finance department
- They will be set by managers to help achieve the corporate objectives.
- They must be SMART to be effective.

## Understanding financial objectives

- **Financial aims** – Broad goals for the finance department
- **Financial objectives** – Specific SMART targets for the departments to achieve their aims
- **Financial strategies** – Long-term/medium-term plans, devised at senior management level; designed to achieve objectives
- **Financial tactics** – Short-term financial measures adopted to meet needs of a short-term threat or opportunity
- Each department must achieve their aims and objectives to help achieve the overall company objectives.



Hierarchy of objectives

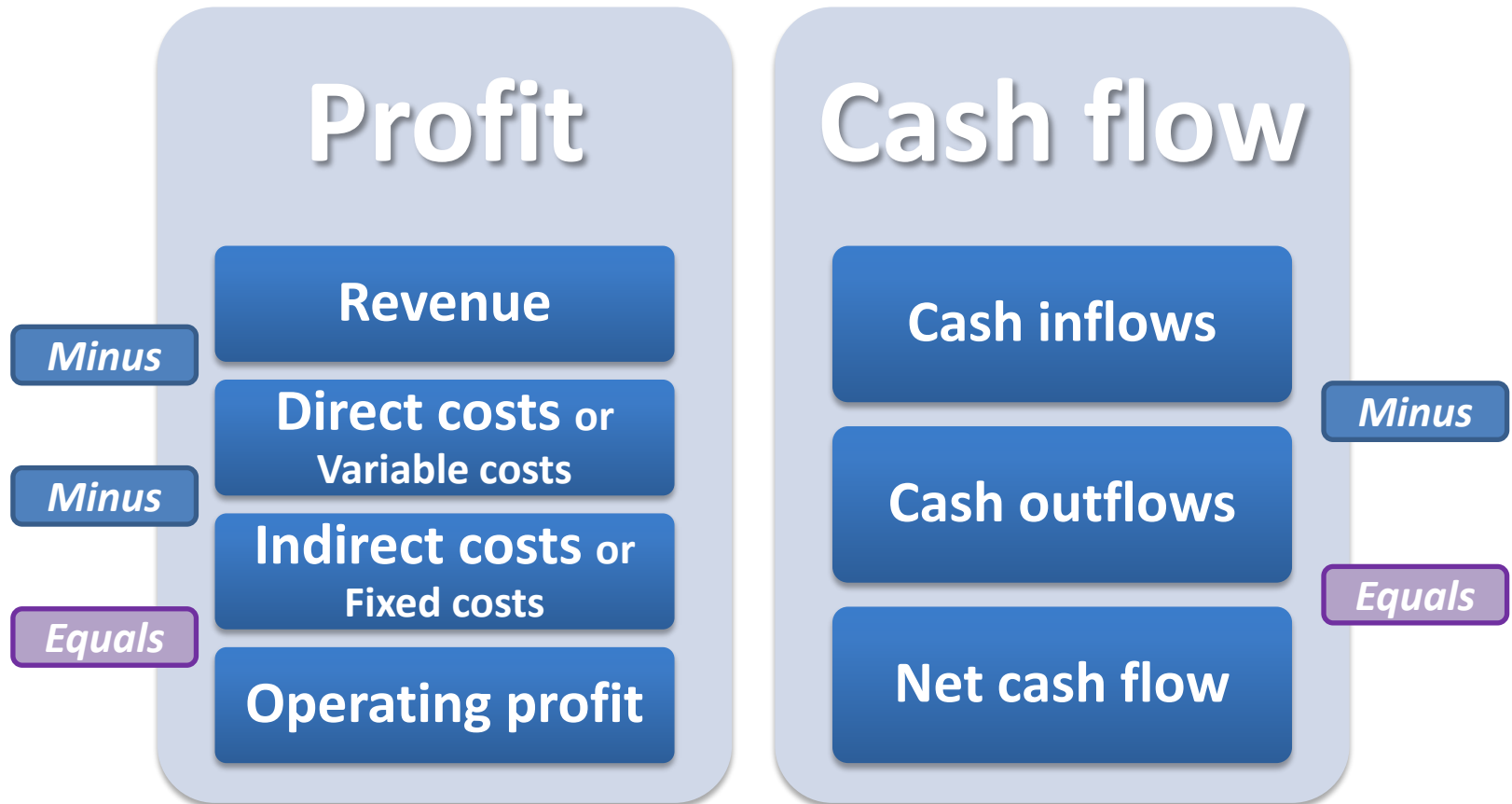


# Cash flow

- **Cash flow:** the total amount of cash flowing into the business (inflows) minus all the cash leaving the business (outflows) over a period of time.
- **Cash inflows:** receipts of cash into the business such as those from customers from sales, loans taken out, rent charged, selling of assets.
- **Cash outflows:** payments of cash leaving the business such as for purchasing raw materials from suppliers, purchasing other goods or equipment, repaying loans and interest.



# Profit and cash are not the same





# The distinction between cash flow and profit

### Cash and profit are not the same

- **Cash** is the actual money held within a business in the short term that it is able to use to pay debts.
- **Profit** is the final result at the end of a financial period where the revenue is greater than the total costs.
- So a business may look profitable on its accounts but may constantly struggle with low cash levels.
- If a business is unable to pay its debts it is known to be **insolvent**.
- So even profitable businesses can fail because of poor cash flow and an inability to pay their short-term debts. Firms with low profit may still survive with reasonable cash flow.



# The distinction between cash flow and profit

**Reasons for a business to appear profitable but have poor cash flow and liquidity include:**

- A business that makes sales to customers on credit will be paid at an agreed later date. Therefore the sale will count immediately as revenue but will not become a cash inflow until it has been received.
- Likewise payments for goods from suppliers will be shown as a cost on the accounts but will not be a cash outflow until they are actually paid.
- Purchased stock appears as an asset for the business but means cash is tied up in that form.
- Payment for non-current assets will be a cash outflow to the supplier when they are paid for but will not be shown as a cost on the income statement.



# The distinction between cash flow and profit

- Non-current assets are counted as assets on the balance sheet, not costs to impact profit.
- Depreciation would count as a cost but not a cash outflow.

Therefore be careful when talking about profit and cash. A business must make a profit to be viable but more importantly a firm must have good cash flow to be able to actually pay its debts and avoid being forced into bankruptcy or **liquidation**.





# Discussion question

What are the **main aims/objectives** likely to be for the finance/accounting department in a medium- to large-sized business?

Financial objectives come in many forms. Here are some examples:

- Revenue, costs and profit targets
- Cash flow targets
- Targets for investment (capital expenditure) levels
- Capital structure targets



# Revenue, costs and profit targets

Targets in this area might include:

- **Sales growth and maximisation** – Through better promotion, changing prices, etc.
- **Profit growth and maximisation** – This can be done through charging higher prices, generating higher sales, minimising costs, etc.
- **Cost minimisation** – For example, reducing raw material costs, wage levels, rent, etc. Cost minimisation allows firms to maximise profit margins and to possibly reduce prices to pursue a cost leadership strategy.
- **Cost leadership** – Minimising costs to charge low prices to differentiate the business and develop sustainable competitive advantage (Porter's Generic Strategies).



# Cash flow objectives

Examples of cash flow objectives might include:

- Maintaining a minimum closing monthly cash balance
- Improving inflows
- Minimising outflows
- Reducing the reliance on bank overdrafts to minimise high interest payments
- Spreading cash inflows and outflows more evenly over the year
- Improving liquidity, for example by holding less stock and improving credit terms with suppliers and customers



# ROCE targets

**ROCE targets** – Profit is the ultimate measure of success and needs to be compared with the size of the business.

**Capital employed** – Value of resources used by a business. It is an excellent guide to a firm's size.

Profit targets are often expressed as a return on capital employed (ROCE)

$$\text{ROCE} = \frac{\text{Operating profit}}{\text{Capital employed}} \times 100$$

Targets in this area might include:

- To improve on last year's ROCE
- To be better than the average in their industry
- To be better than rivals

A firm may set less ambitious targets in periods of recession.



# Capital structure targets

- The capital structure is how a firm finances its overall operations and growth using different sources of funds.
- Firms will have different attitudes about the level of debt they are willing to hold.
- They will also set targets of how much loan debt they will hold, how much of the firm's capital they will sell as shares to raise finance for growth and what level of retained profit they will be able to use.
- Often shareholders/owners will have a say in the capital structure and will have different views on the level of risk they are willing to take.
- The cost of finance will also influence a firm's decisions about their capital structure, for example, interest payments on loans.



# Capital structure targets

- A growing firm is more likely to have high debt to fund its expansion.
- **Gearing** – The percentage of capital invested in the firm that has come from loans.
- Firms may set targets of what level of gearing they are willing to have. Above 50 per cent is considered high capital gearing while below 25 per cent is described as low capital gearing.
- Different owners and managers will have different views on what level of gearing is acceptable.
- However, many firms will still take out loans to fund their business even if it can be covered by retained profit, to help spread costs over a longer period of time improving liquidity.



# Other financial targets

### Investment (capital expenditure) levels

- Targets may be set on the level of spending on expansion and growth, acquiring capital equipment and non-current assets, for example, machinery, property and vehicles.
- These targets will change depending on the financial position of the business, their profit levels, the spending of their rivals and the state of the economy.

### Shareholder targets

- A business must satisfy its shareholders who may assess a firm's success in terms of the dividends they receive. A high dividend is likely to link to high profits.

Targets in this area might include:

- High dividend per share – Dividend is the payment made to shareholders as part of the profit made.
- High dividend yield – Dividend paid compared to the market value of the share.
- Increase the share price – Share prices rise as the company becomes more successful and people want to purchase its shares.
- High earnings per share – Total profit dividend/number of shares. This shows the profit made by each share and is therefore a good indicator of efficiency.



# Discussion question

**Why** should the finance/accounting department in a medium- to large-sized business **set objectives?**





# Reasons for setting financial objectives

- Act as a focus for decision making and effort
- Can be used to measure success/failure of the department
- Will help to improve the co-ordination of staff by giving teams and departments a common purpose and direction
- Allows firms to improve efficiency and performance in the future by analysing the reasons for success or failure in different areas, for example, variance analysis
- Allows shareholders to assess whether the business is going to provide a worthwhile investment
- Informs investors/owners of the company's future intentions



# Discussion question

What internal and external factors will influence a firm's financial objectives and decisions?



# External and internal influences on financial objectives and decisions

## Internal

- Mangers' attitudes to risk and finance
- Owners' views
- Human resource issues, e.g. staff skills
- Type of product sold
- Legal structure of the firm
- Operational issues, e.g. stock levels needed, investment required in assets and technology
- Resources available

## External

- State of the economy
- Inflation and interest rates
- Political factors, e.g. legislation and tax
- Competitor actions and performance
- Suppliers
- Customers' needs and expectations



# Example business: Barratt Developments

- Barratt Developments Plc has been building homes for more than 50 years in the UK. They are one of the nation's largest housebuilders with more than 5,000 direct employees and 27 divisions throughout Britain.
- Their vision is to be recognised as the nation's leading housebuilder, creating communities where people aspire to live.
- The company planned to return £950m to its shareholders between 2014 and 2017 after doubling their profits.
- In its accounts for the year ended 30 June 2014 it posted a 103.4 per cent rise in profit before tax to £390.6m, up from £192m in 2013.



# Example business: Barratt Developments

- Its return on capital employed (ROCE) increased to 19.5 per cent, from 11.5 per cent the year before, with Barratt setting a new ROCE target of at least 25 per cent for 2017.
- Overall Barratt's revenue increased by 21.1 per cent for the period to £3.1bn, compared with £2.6bn the prior year.
- Barratt Chief Executive Mark Clare said: 'This significant improvement in performance has been driven by the £3.8bn we have committed to land investment since mid-2009, together with the recovering market and improvements in design, quality and efficiency.'

**Discuss:** Why do you think Barratt Developments is paying this money to shareholders?



# Exam-style questions

- **Explain** one internal factor which might influence the financial objectives of a television manufacturer. (4 marks)
- **Analyse** how expanding into a foreign market might improve profitability for a UK high-street clothing retailer. (9 marks)
- **Discuss** whether it is more important for a UK supermarket such as Sainsbury's to focus on cash-flow targets rather than profit targets during difficult economic periods. Justify your view. (16 marks)

### Exam tips:

- Look at the trigger words and points awarded to decide what exam skills are expected.
  - **Application only:** Explain.
  - **Analysis and application questions:** Explain why, analyse, examine.
  - **Evaluation/judgement, analysis and application questions:** 'Evaluate', 'justify', 'to what extent', 'in your opinion', 'discuss'.



# Summary

- Financial targets are essential to ensure the department works towards achieving the overall corporate objectives.
- They give the department motivation and help them to measure success.
- They also help their stakeholders to know what the business is trying to achieve.
- Firms will have different targets depending on their situation and the external environment.
- Cash flow may be more important in the short term particularly during difficult times but in the long term all firms must make profit.



# Unit 5 – Decision making to improve financial performance

## Setting financial objectives: Activity

### Task 1

Write down all the tasks you think the finance department will be involved with:

### Task 2: The distinction between cash and profit

	Cash	Profit
Define:		
What is liquidity?		

Give two more examples that show how cash and profit are different:

For example: A firm may have sold goods on credit so on the income statement it would be recorded as revenue and therefore make the firm look profitable at the end of the financial year. However if they have not yet received the payment from customers it will not yet have been received as cash meaning they would be unable to use it to pay short-term debts.

1.	
2.	





## Unit 5 – Decision making to improve financial performance

### Task 3: Influences on financial objectives – Mind map

Produce a mind map identifying all of the **internal** and **external** influences when setting financial objectives.

### Task 4: Diageo's research

Diageo is an international drinks manufacturer and distributor. Its strategy is to increase growth and profit margins in a sustainable, responsible way, to deliver value creation for its shareholders over the long term.

Investigate Diageo's strategy:

<http://www.diageo.com/ensc/ourbusiness/aboutus/pages/our-strategy.aspx>

- List three examples of Diageo's financial objectives
- List some of the strategies it intends to use to achieve these objectives.