3 The relationship between financial management, management accounting and financial accounting

3.1 Management Accounting

As outlined in the previous paragraph, Financial Management is mainly concerned with making decisions for the long-term future of the company.

It tends to be long-term decision making, involves making forecasts for the future and needs much external information (e.g. knowledge of competitors). The purpose is to make decisions which end up achieving the objectives of the company.

Once the long term decisions have been made, they need to be implemented and controlled. This is Management Accounting.

> Management Accounting involves making short-term decisions as to how to implement the long-term strategy and involves the setting up of a control system in order to measure how well objectives are being achieved in order that corrections may be made if necessary.

- It tends to be short-term (the coming year), and involves both past information and forecasts for the future.

3.2 Financial Accounting

- Financial Accounting is the reporting to stakeholders – primarily shareholders – of how the company has performed and therefore effectively how well the Financial Manager and Management Accountant are doing their jobs.

- The Financial Accountant is fulfilling a legal requirement to report the profits, and it is not their role to look for ways of performing better – that is the job of the Financial Manager.

- The Financial Accountant is only looking at past information and information internal to the company.

4 The relationship of financial objectives and organisational strategy

4.1 A strategy is the course of action taken in order to attempt to achieve an objective.

The Financial Manager needs to decide on strategies for the raising of finance, for the investment of capital, and for the management of working capital.

However, before he can decide on these strategies he needs to identify what the objectives of the company are.

All private sector companies will have the objective of being profitable, but this objective can be stated in various ways (e.g. maximising the return on capital employed; maximising the dividend payable to shareholders). The objectives are different for the various stakeholders in a company (e.g. the shareholders, the debt lenders, the employees) and it is the objectives that will determine the strategies to be followed.

4.2 Maximising and Satisficing

One problem for the Financial Manager (as discussed more in the next paragraph) is to satisfy the objectives of several stakeholders at the same time. For example, reducing wages might increase profits and might satisfy shareholders, but would be unlikely to satisfy employees!

It is up to the Financial Manager to consider the various stakeholders and their objectives and decide on a strategy to achieve the relevant objectives. It is however obviously often difficult to

(c) Collection procedures:

   x Set clearly defined procedures to be followed. Set timings for issuing demand letters, making chasing telephone calls, and stopping deliveries.

   x Decide when outside assistance is needed (e.g. the use of collection agencies or lawyers)

   x Compare the cost of taking direct legal action with that of using outside help.

(d) Charge interest on overdue invoices:

   x In the UK, large powerful companies have a bad reputation for paying their small suppliers very slowly. As a result, the government introduced the 'Late Payment Act' in 1998 which allows small companies to charge large companies interest at 8% over base rate on invoices unpaid after 30 days.

2.2 Invoice discounting and factoring

Invoice discounting is the selling of an invoice to a third party (usually a bank) for a lower (discounted) amount. This way the supplier gets cash immediately and it is the bank who has to wait for payment (hence the lower or discounted amount).

Factoring is paying another company to administer all or part of the receivables ledger.

Depending on the fee paid to the factor, different facilities may be bought.

The basic level of factoring involves paying the factor to handle all the administration – maintaining the sales ledger and collecting the debts.

For a higher fee, the factor will advance money to the company before the debts have been collected. For example, the factor may advance 80% of the value of sales immediately on invoicing.

For a higher fee still, the factor may accept responsibility for any bad debts – the company is effectively insured against bad debts. This is known as 'non-recourse factoring'. (Normal factoring, where the company keeps the responsibility for any bad debts, is known as 'with-recourse factoring')

2.3 Examination arithmetic on receivables management

Most arithmetical questions in the examination relating to receivables management involve consideration as to whether or not a change in collection policy is worthwhile.

There are two techniques that you must be aware of – being able to consider whether or not it is worthwhile offering a simple settlement discount, and being able to consider whether or not a change in collection policy (either by using discounts or using a factor) is worthwhile.

(a) Simple settlement discount

Example 1

Customers currently take three months credit. We are considering offering a discount of 4% for payment within one month.

Sales are $12,000,000 p.a..

We are paying overdraft interest of 20% p.a..

Calculate the effective % cost p.a. of the discount.

Should we offer the discount?

4 Discounted Cash Flow – annuities and perpetuities

Most examples in the examination are like the one in example 1 - with differing cash flows each year, each of which needs to be discounted separately.

However, you will sometimes be presented with cash flows that are equal each year, in which case there is a faster and simpler approach to discounting.

An equal cash flow each year (e.g. $10,000 p.a. for 10 years) is known as an annuity.

If the annuity were expected to continue for ever, it is known as a perpetuity.

4.1 Annuities

The discount factor for an annuity may be calculated using the following formula:

$$\text{Annuity discount factor} = \frac{1-(1+r)^{-n}}{r}$$