FACTFILE: GCE PROFESSIONAL BUSINESS SERVICES

Rewarding Learning

UNIT AS 3: INTRODUCTION TO FINANCIAL DECISION MAKING

Learning Outcomes

Students should be able to:

- Demonstrate understanding of the importance of effective financial decision making for business operations;

Decision Making

Decision making is the process of determining and selecting the most appropriate choice of action from a range of alternatives, in order to ensure the best outcome.

In the context of the financial environment, this would imply that managers make decisions which should lead to the best financial outcome for a business.

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Financial Decision Making in a Business

Decision making in a business often takes place across three different levels, which are inter-related:

Strategic: decision making at this level of an organisation is often by the senior management team/directors. The impact of such decisions often tend to be of a long-term nature (around 5 years or more), and often involve a degree of complexity, e.g. drawing up a cash flow forecast for a strategic plan, aimed at monitoring the cash flows in an overseas market.

Tactical: decision making at this level of an organisation is often by the senior management team. The impact of such decisions often tend to be of a mid- term to long-term nature (around 2 to 5 years), and often involve a degree of complexity, e.g. implementing the arrangements to operate new business in an overseas markets, detailing the monthly cash flows related to the acquisition of an existing business or opening new offices.

Operational: decision making at this level of

an organisation is often by the departmental managers or staff. The impact of such decisions often tend to be of a short-term nature (daily or up to one year), and typically routine, e.g. monitoring and collection of daily cash flows aimed at improving net cash flows for an overseas business.

Financial Decision Making Scenarios in a Business:

A Professional Business Services Firm might provide client businesses with advice in relation to the following operational decision making scenarios:

Sales Revenues:
If a business has suffered a loss of sales revenue, the following decisions might be taken:

- Decrease sales prices in an effort to induce customers to purchase more, thus increasing quantities sold;
- Undertake a promotional campaign to increase customer awareness of the product/service and thus increase sales quantities/revenues;
- Proceed with entry into a new market, on the basis of agreed market segments, e.g. overseas market, or on the basis of age or gender.

Cost of Sales:
- Decrease the costs of actually providing the goods or services to customers in an effort to improve efficiency;
- Reduce the levels of inventory in order to improve cash flows;
- Reduce unit costs in order to improve mark-up percentage and cash flows.

Profitability:
- Reduce costs of trading and expenses incurred in order to maintain or improve profit margins;
- Review operational decisions and investigate ways of improving efficiency and increasing cash flows and profitability.

Assets:
- **Non-Current Assets** – if the acquisition of assets such as vehicles and equipment are expensive and involve large cash outlays, then a consultant might suggest that such assets might be leased or acquired using alternative sources of finance such as hire purchase/ leasing rather than paid for immediately by cash.
- **Current Assets** – if cash flow is short, a consultant might suggest ways in which cash flows might be improved:
- **Inventories** – if the business has large amounts of inventory, it may be useful to consider discounting in order to sell the goods quickly to customers and improve cash flows;
- **Trade Receivables** - if the business has large amounts of money tied up in customer accounts, then it might be appropriate to offer a discount to encourage early payment or enlist the services of a debt factoring agency in order to improve cash flows;
- **Bank** – a regulated financial services provider might suggest ways in which surplus cash flows might be invested in order to improve return on investments, e.g. long term bonds, stock market investments or acquisition of profitable businesses.

Liabilities:
Liabilities are also presented within the Statement of Financial Position according to the length of time a business expects the liability to be outstanding for payment.

Non-Current Liabilities:
Loans – advice may be provided to a client to ensure that sufficient loan finance is available beyond a one-year accounting period in order to facilitate a long-term project, e.g. setting up a new factory.

Current Liabilities:
Liabilities that the business expects to pay within a one-year accounting period (e.g. include trade payables/bank overdraft/accruals.)

Trade Payables:
A professional business services provider might advise a client that in order to improve cash flows in relation to the amount of trade payables outstanding, it might be more appropriate to negotiate a longer time span with creditors in order to repay monies or seek a reduction in the amount of interest charged on a debt.

Equity:
In relation to the value of funds within the business which can be attributed to the owner, a professional business services adviser might suggest that in order to increase the value of equity, it might be more appropriate to reduce the amounts paid to owners e.g. drawings taken out of the business, dividends paid; alternative ways of improving equity investments include; reducing costs, improving efficiency or reinvesting profits for the future.

Management Accounting:

Costing: Management will typically keep detailed records of costs of production, sales and expenses. A consultant might review the costs incurred by a business and suggest ways in which improvements can be achieved in a client business:

- Reductions in material costs – bulk buying of component parts might yield a reduction in unit costs;
- Reductions in labour costs – employment of younger members of staff might reduce labour costs to the minimum wage rates, but the experience provided by more senior staff may be lost to the business;
- Reductions in expenses – money should only be spent on essential costs in support of core business activities, e.g. marketing and staff wages, in order to achieve core objectives.

Planning: Management will typically need to plan the activities of a business. A professional business services provider might suggest that a system of planning or budgeting is designed and implemented. This would entail:

- Design and implement an agreed system of budgeting, e.g. departmental budgets rolled up in a hierarchical structure to the board of directors/management committee;
- Implementation of the budget process, through preparation of the master budget and comprising subsidiary budgets such as sales budget, production budget, labour budget, overhead budget and cash budget;

Control: Review of budgets in order to check that actual activities are progressing in accordance with the plan (budget). The consultant might suggest that:

- Differences may be investigated using variance analysis;
- Follow-up reporting is undertaken, in order to suggest ways in which actual performance can be im-proved and therefore enhance business performance.

Financial Management:

In a Limited Company, managers are tasked with the responsibility of maximising the value of the shareholder's investment. An authorised financial services provider or professional business services firm might provide advice in relation to:

Retained Earnings: These are funds that the company has earned for the accounting period, after the deduction of expenses for the accounting period. It is transferred to the Profit/Loss Reserve as part of shareholders funds (equity). The Profit/Loss Reserve is the accumulation of profits/losses from previous accounting periods. Shareholders need to be confident that managers are making financial decisions to retain their confidence and continue to invest in the business, through ensuring growth in profits.

Dividends: These are payments to shareholders representing a return on their investment. Dividends are usually on an annual basis (although some companies opt to pay an Interim Dividend, during the financial period). Dividends can only be paid if sufficient profits are available and funds permit and so must be set at an affordable rate (e.g. 3%, 5% or 10%) – this serves two functions:

- provides a financial return to investors in terms of investment income;
- provides an inducement to shareholders to continue to invest in the business.

Shareholders Funds (Owners Equity): This is the amount of money invested in the company by shareholders, represented by their initial investment (number of shares and the value) and the retained earnings accrued since the start of trading (Profit/Loss Reserve). Other reserves may be included in this section (e.g. Share Premium, Revaluation Reserve) which also form part of equity. Advice may be provided in order to increase the value of such equity, this will enhance shareholder value.

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Pension Advice: Businesses are obliged to pay part of the pension costs for their employees. This will cost the business money. An authorised financial adviser or pensions consultant will provide advice to company managers about the amount of money to be paid each month/year to the pension fund, in order to ensure that pensions can be paid to all staff in the future. This involves using the services of professional actuaries, insurance consultants and financial advisers in order to make the most appropriate decisions and therefore arrive at a cost which both business and staff can afford to pay.

Intangible Assets/Investments:

A business might acquire intangible assets and/or investments. A professional business services firm might provide advice in the context of:

Intangible Assets - a business might have unique business processes or knowledge in relation to the provision of specific goods/services. This may involve the holding of copyright, brand names, patents and similar intangible assets. A consultant may be able to provide advice regarding the protection of such assets from competitors, fraudulent traders and thus improve future business income.

Investments - a business might have unique business processes or knowledge in relation to the provision of specific goods/services. This may involve the investment of money into other companies/businesses, e.g. acquisition of a business located in New York (USA) might allow a local business access to the American market, thus increasing sales revenues or market share.

A consultant may be able to provide a valuation of the American-based business for insurance purposes, thus protecting the assets from fraud, damage, fire and theft.

Importance of Effective Decision Making:

Effective decision making is important for the following reasons:

- To enable management to exercise their 'stewardship' function and account for all the resources under their control;
- To enable management to report on the use of the resources and the extent to which such resources were used efficiently;
- To enable management to plan ahead in order to achieve business objectives, such as survival and/or growth;
- To enable management to meet the needs of stakeholders, e.g. customers, staff, management, government and others.
- To enable management to achieve non-financial objectives, such as corporate social responsibility, or ethical goals e.g. improve the ethical behaviour of staff and create a positive image of the business globally, nationally or locally;
- To enable management to meet their legal obligations, e.g. health and safety laws, minimum wage regulations, industry-specific legislation (food standards laws, gambling laws, licencing laws).

Summary

Decision making might be thought of as a process of determining and selecting the most appropriate choice of action from a range of alternatives, in order to ensure the best outcome.

In the context of the financial environment, this would imply that managers make decisions which should lead to the best financial outcome for a business. Such decision making occurs at various levels of a business from strategic to operational, and across different scenarios.

Questions:

1. Explain what is meant by the term 'decision making' using three different examples.

2. Imagine your local mobile phone shop has recently announced that it is ceasing trading at the end of the month. The manager has indicated that problems have led to her decision to close the business:
   - Falling sales
   - Lack of car parking
   - Lack of a website
   - Current ratio of 0.5:1; and
   - Poor staff morale

   You are a Management Consultant. Advise the manager of the strategies required to reverse the decision to close and to continue trading.

3. Evaluate the importance of decision making by managers to a shareholder. Support your answer with reference to three different scenarios.