CIMA

Subject BA1

Fundamentals of Business Economics

Study Text

CIMA PUBLISHING

KAPLAN PUBLISHING

Published by: Kaplan Publishing UK

Unit 2 The Business Centre, Molly Millars Lane, Wokingham, Berkshire RG41 2QZ

Copyright © 2019 Kaplan Financial Limited. All rights reserved.

No part of this publication may be reproduced, stored in a retrieval system or transmitted in any form or by any means electronic, mechanical, photocopying, recording or otherwise without the prior written permission of the publisher.

Acknowledgements

We are grateful to the CIMA for permission to reproduce past examination questions. The answers to CIMA Exams have been prepared by Kaplan Publishing, except in the case of the CIMA November 2010 and subsequent CIMA Exam answers where the official CIMA answers have been reproduced. Questions from past live assessments have been included by kind permission of CIMA,

Notice

The text in this material and any others made available by any Kaplan Group company does not amount to advice on a particular matter and should not be taken as such. No reliance should be placed on the content as the basis for any investment or other decision or in connection with any advice given to third parties. Please consult your appropriate professional adviser as necessary.

Kaplan Publishing Limited and all other Kaplan group companies expressly disclaim all liability to any person in respect of any losses or other claims, whether direct, indirect, incidental, consequential or otherwise arising in relation to the use of such materials.

Kaplan is not responsible for the content of external websites. The inclusion of a link to a third party website in this text should not be taken as an endorsement.

British Library Cataloguing in Publication Data

A catalogue record for this book is available from the British Library.

ISBN: 978-1-78740-486-1

Printed and bound in Great Britain

Contents

Introduction

How to Use the Materials

These Kaplan Publishing learning materials have been carefully designed to make your learning experience as easy as possible and to give you the best chances of success in your CIMA Cert BA Objective Test Examination.

The product range contains a number of features to help you in the study process. They include:

- a detailed explanation of all syllabus areas
- extensive 'practical' materials
- generous question practice, together with full solutions.

This Study Text has been designed with the needs of home-study and distance-learning candidates in mind. Such students require very full coverage of the syllabus topics, and also the facility to undertake extensive question practice. However, the Study Text is also ideal for fully taught courses.

The main body of the text is divided into a number of chapters, each of which is organised on the following pattern:

- **Detailed learning outcomes.** These describe the knowledge expected after your studies of the chapter are complete. You should assimilate these before beginning detailed work on the chapter, so that you can appreciate where your studies are leading.
- **Step-by-step topic coverage.** This is the heart of each chapter, containing detailed explanatory text supported where appropriate by worked examples and exercises. You should work carefully through this section, ensuring that you understand the material being explained and can tackle the examples and exercises successfully. Remember that in many cases knowledge is cumulative: if you fail to digest earlier material thoroughly, you may struggle to understand later chapters.
- **Activities.** Some chapters are illustrated by more practical elements, such as comments and questions designed to stimulate discussion.
- **Question practice.** The text contains exam-style objective test questions (OTQs).
- **Solutions.** Avoid the temptation merely to 'audit' the solutions provided. It is an illusion to think that this provides the same benefits as you would gain from a serious attempt of your own. However, if you are struggling to get started on a question you should read the introductory guidance provided at the beginning of the solution, where provided, and then make your own attempt before referring back to the full solution.

If you work conscientiously through this Official CIMA Study Text according to the guidelines above you will be giving yourself an excellent chance of success in your Objective Text Examination. Good luck with your studies!

Quality and accuracy are of the utmost importance to us so if you spot an error in any of our products, please send an email to mykaplanreporting@kaplan.com with full details, or follow the link to the feedback form in MyKaplan.

Our Quality Coordinator will work with our technical team to verify the error and take action to ensure it is corrected in future editions.

Icon explanations

Definition – These sections explain important areas of knowledge which must be understood and reproduced in an assessment environment.

Key point – Identifies topics which are key to success and are often examined.

Supplementary reading – These sections will help to provide a deeper understanding of core areas. The supplementary reading is **NOT** optional reading. It is vital to provide you with the breadth of knowledge you will need to address the wide range of topics within your syllabus that could feature in an assessment question. **Reference to this text is vital when self-studying.**

Test your understanding – Following key points and definitions are exercises which give the opportunity to assess the understanding of these core areas.

Illustration – To help develop an understanding of particular topics. The illustrative examples are useful in preparing for the Test your understanding exercises.

Exclamation mark – This symbol signifies a topic which can be more difficult to understand. When reviewing these areas, care should be taken.

Study technique

In this section we briefly outline some tips for effective study during the earlier stages of your approach to the Objective Test Examination. We also mention some techniques that you will find useful at the revision stage. Use of effective study and revision techniques can improve your chances of success in the CIMA Cert BA and CIMA Professional Qualification examinations.

Planning

To begin with, formal planning is essential to get the best return from the time you spend studying. Estimate how much time in total you are going to need for each subject you are studying. Remember that you need to allow time for revision as well as for initial study of the material.

With your study material before you, decide which chapters you are going to study in each week, and which weeks you will devote to revision and final question practice.

Prepare a written schedule summarising the above and stick to it!

It is essential to know your syllabus. As your studies progress you will become more familiar with how long it takes to cover topics in sufficient depth. Your timetable may need to be adapted to allocate enough time for the whole syllabus.

Students are advised to refer to the CIMA website, www.cimaglobal.com, to ensure they are up-to-date.

Students are advised to consult the syllabus when allocating their study time. The percentage weighting shown against each syllabus topic is intended as a guide to the proportion of study time each topic requires.

Tips for effective studying

(1) Aim to find a quiet and undisturbed location for your study and plan as far as possible to use the same period of time each day. Getting into a routine helps to avoid wasting time. Make sure that you have all the materials you need before you begin so as to minimise interruptions.

(2) Store all your materials in one place, so that you do not waste time searching for items every time you want to begin studying. If you have to pack everything away after each study period, keep your study materials in a box, or even a suitcase, which will not be disturbed until the next time.

(3) Limit distractions. To make the most effective use of your study periods you should be able to apply total concentration, so turn off all entertainment equipment, set your phones to silent mode, and put up your ‘do not disturb’ sign.

(4) Your timetable will tell you which topic to study. However, before diving in and becoming engrossed in the finer points, make sure you have an overall picture of all the areas that need to be covered by the end of that session. After an hour, allow yourself a short break and move away from your Study Text. With experience, you will learn to assess the pace you need to work at. Each study session should focus on component learning outcomes – the basis for all questions.

(5) Work carefully through a chapter, making notes as you go. When you have covered a suitable amount of material, vary the pattern by attempting a practice question. When you have finished your attempt, make notes of any mistakes you made, or any areas that you failed to cover or covered more briefly. Be aware that all component learning outcomes are examinable.

(6) Make notes as you study, and discover the techniques that work best for you. Your notes may be in the form of lists, bullet points, diagrams, summaries, 'mind maps' or the written word, but remember that you will need to refer back to them at a later date, so they must be intelligible. If you are on a taught course, make sure you highlight any issues you would like to follow up with your lecturer.

(7) Organise your notes. Make sure that all your notes, calculations etc. can be effectively filed and easily retrieved later.

Progression

There are two elements of progression that we can measure: how quickly students move through individual topics within a subject; and how quickly they move from one course to the next. We know that there is an optimum for both, but it can vary from subject to subject and from student to student. However, using data and our experience of student performance over many years, we can make some generalisations.

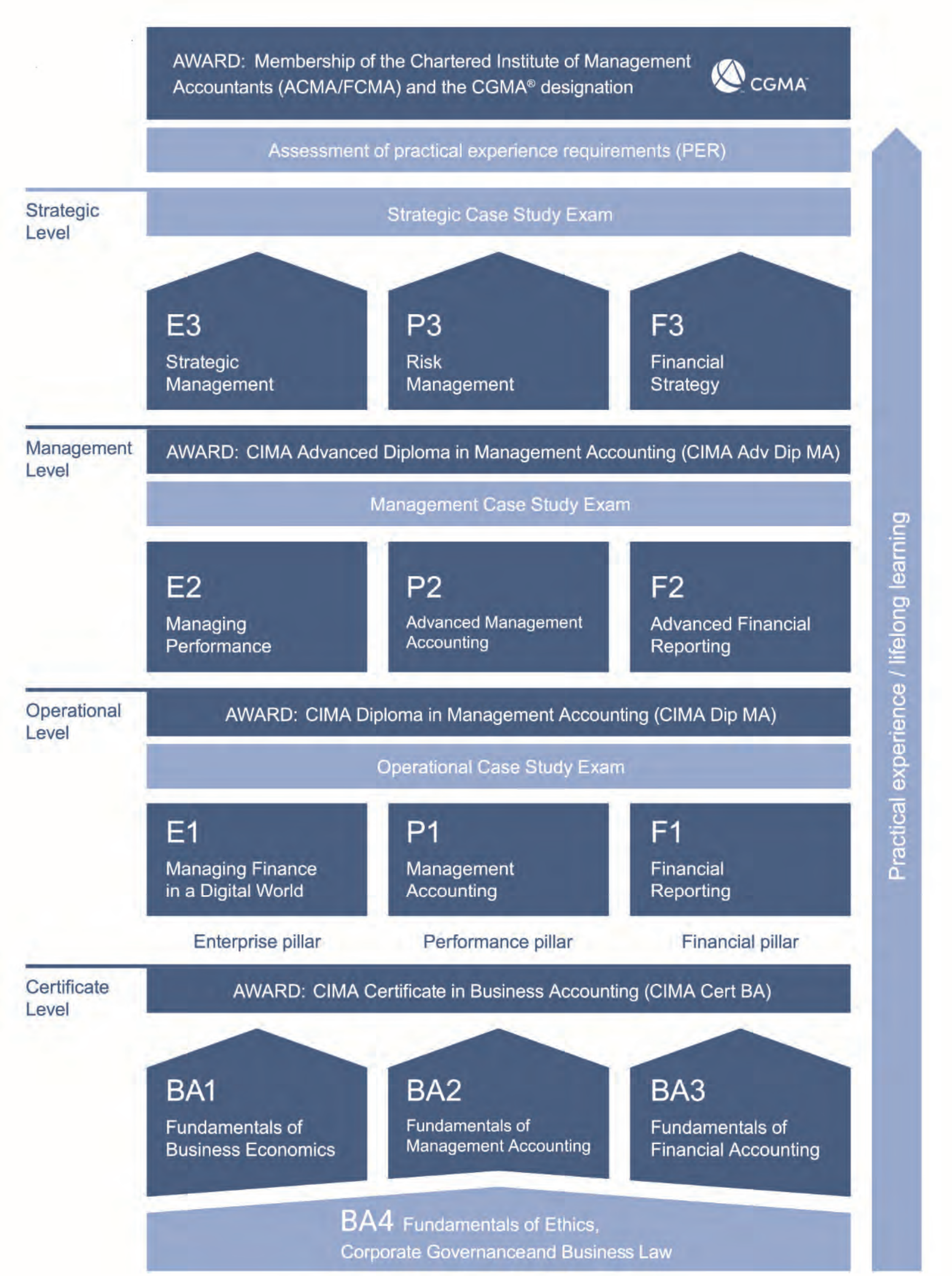
A fixed period of study set out at the start of a course with key milestones is important. This can be within a subject, for example 'I will finish this topic by 30 June', or for overall achievement, such as 'I want to be qualified by the end of next year'.

Your qualification is cumulative, as earlier papers provide a foundation for your subsequent studies, so do not allow there to be too big a gap between one subject and another. For example, E1 *Managing finance in a digital world* builds on your knowledge of the finance function from certificate level and lays the foundations for E2 *Managing performance* and all strategic papers particularly E3 *Strategic management* and P3 *Risk management*.

We know that exams encourage techniques that lead to some degree of short term retention, the result being that you will simply forget much of what you have already learned unless it is refreshed (look up Ebbinghaus Forgetting Curve for more details on this). This makes it more difficult as you move from one subject to another: not only will you have to learn the new subject, you will also have to relearn all the underpinning knowledge as well. This is very inefficient and slows down your overall progression which makes it more likely you may not succeed at all.

In addition, delaying your studies slows your path to qualification which can have negative impacts on your career, postponing the opportunity to apply for higher level positions and therefore higher pay.

You can use the following diagram showing the whole structure of your qualification to help you keep track of your progress. Make sure you carefully review the 2019 CIMA syllabus transition rules and seek appropriate advice if you are unsure about your progression through the qualification.



Reproduced with permission from CIMA

Objective Test

Objective Test questions require you to choose or provide a response to a question whose correct answer is predetermined.

The most common types of Objective Test question you will see are:

- multiple choice, where you have to choose the correct answer(s) from a list of possible answers – this could either be numbers or text
- multiple response with more choices and answers, for example, choosing two correct answers from a list of five available answers – this could be either numbers or text
- number entry, where you give your numeric answer to one or more parts of a question, for example, gross profit is $25,000 and the accrual for heat and light charges is $750.
- drag and drop, where you match one or more items with others from the list available, for example, matching several accounting terms with the appropriate definition
- drop down, where you choose the correct answer from those available in a drop down menu, for example, choosing the correct calculation of an accounting ratio, or stating whether an individual statement is true or false
- hot spot, where, for example, you use your computer cursor or mouse to identify the point of profit maximisation on a graph
- other types could be matching text with graphs and labelling/indicating areas on graphs or diagrams.

CIMA has provided the following guidance relating to the format of questions and their marking:

- questions which require narrative responses to be typed will not be used
- for number entry questions, a small range of answers will be accepted. Clear guidance will usually be given about the format in which the answer is required e.g. ‘to the nearest $’ or ‘to two decimal places’
- item set questions provide a scenario which then forms the basis of more than one question (usually 2–4 questions). These sets of questions would appear together in the test and are most likely to appear in BA2 and BA3
- all questions are independent so that, where questions are based on a common item set scenario, each question will be distinct and the answer to a later question will not be dependent upon answering an earlier question correctly
- all items are equally weighted and, where a question consists of more than one element, all elements must be answered correctly for the question to be marked correct.

Throughout this Study Text we have introduced these types of questions, but obviously we have had to label answers A, B, C etc. rather than using click boxes. For convenience we have retained quite a few questions where an initial scenario leads to a number of sub-questions. There will be questions of this type in the Objective Test Examination but they will rarely have more than three sub-questions.

Guidance re CIMA on-screen calculator

As part of the CIMA Objective Test software, candidates are provided with a calculator. This calculator is on-screen and is available for the duration of the assessment. The calculator is available in Objective Test Examinations for BA1, BA2 and BA3 (it is not required for BA4).

Guidance regarding calculator use in the Objective Test Examinations is available online at: https://connect.cimaglobal.com/

CIMA Cert BA Objective Tests

The Objective Tests are a two-hour assessment comprising compulsory questions, each with one or more parts. There will be no choice and all questions should be attempted. The numbers of questions in each assessment are as follows:

BA1 Fundamentals of Business Economics – 60 questions

BA2 Fundamentals of Management Accounting – 60 questions

BA3 Fundamentals of Financial Accounting – 60 questions

BA4 Fundamentals of Ethics, Corporate Governance and Business Law – 85 questions

All questions are equally weighted. All parts of a question must be answered correctly for the question to be marked correct. Where questions are based upon a common scenario, each question will be independent, and answers to later questions will not be dependent upon answering earlier questions correctly.

Structure of subjects and learning outcomes

Each subject within the syllabus is divided into a number of broad syllabus topics. The topics contain one or more lead learning outcomes, related component learning outcomes and indicative syllabus content.

A learning outcome has two main purposes:

(a) to define the skill or ability that a well prepared candidate should be able to exhibit in the examination

(b) to demonstrate the approach likely to be taken in examination questions.

The learning outcomes are part of a hierarchy of learning objectives. The verbs used at the beginning of each learning outcome relate to a specific learning objective e.g.

Calculate the break-even point, profit target, margin of safety and profit/volume ratio for a single product or service.

The verb **'calculate'** indicates a level three learning objective. The following table lists the learning objectives and the verbs that appear in the CIMA Cert BA syllabus learning outcomes.

CIMA VERB HIERARCHY

CIMA place great importance on the definition of verbs in structuring objective tests. It is therefore crucial that you understand the verbs in order to appreciate the depth and breadth of a topic and the level of skill required. The objective tests will focus on levels one, two and three of the CIMA hierarchy of verbs. However, they will also test levels four and five, especially at the management and strategic levels.

Skill level	Verbs used	Definition
Level 3 **Application** How you are expected to apply your knowledge	Apply	Put to practical use
	Calculate	Ascertain or reckon mathematically
	Conduct	Organise and carry out
	Demonstrate	Prove with certainty or exhibit by practical means
	Prepare	Make or get ready for use
	Reconcile	Make or prove consistent/compatible
Level 2 **Comprehension** What you are expected to understand	Describe	Communicate the key features of
	Distinguish	Highlight the differences between
	Explain	Make clear or intelligible/state the meaning or purpose of
	Identify	Recognise, establish or select after consideration
	Illustrate	Use an example to describe or explain something
Level 1 **Knowledge** What you are expected to know	List	Make a list of
	State	Express, fully or clearly, the details/facts of
	Define	Give the exact meaning of
	Outline	Give a summary of

CIMA Cert BA resources

Access to CIMA Cert BA resources including syllabus information is available online at www.cimaglobal.com.

Additional resources

This Study Text is designed to be comprehensive and therefore sufficient to meet the needs of students studying this subject. However, CIMA recognises that many students also want to read around particular topic(s), either to extend their knowledge and understanding, or because it is particularly relevant to their work environment.

CIMA has therefore produced a related reading list for those students who wish to extend their knowledge and understanding, whether for personal interest or to help support work activities as follows:

BA1 – Fundamentals of Business Economics

Principles of Economics 3rd ed.	McDowell & Thom
Applied Economics 12th ed.	Griffiths & Wall
Mathematics for Economists: An Introductory Textbook 4th ed.	Pemberton & Rau

BA2 – Fundamentals of Management Accounting

Management and Cost Accounting	Colin Drury
Management Accounting	Catherine Gowthorpe

BA3 – Fundamentals of Financial Accounting

Financial Accounting – An Introduction	Pauline Weetman
Frank Wood's Business Accounting 1 & 2	Frank Wood & Alan Sangster

BA4 – Fundamentals of Ethics, Corporate Governance and Business Law

Students can find out about the specific law and regulation in their jurisdiction by referring to appropriate texts and publications for their country.

Managing Responsible Business	CGMA Report 2015
Global Management Accounting Principles	CIMA 2015
Embedded Ethical Values: A guide for CIMA Partners	CIMA Report 2014
Business Ethics for SMEs: A Guide for CIMA Partners	CIMA Report 2014
Ethics: Ethical Checklist	CIMA 2014
Ethics Support Guide	CIMA 2014
Acting under Pressure: How management accountants manage ethical issues	CIMA 2012

Information concerning formulae and tables will be provided via the CIMA website, www.cimaglobal.com.

SYLLABUS GRIDS

BA1: Fundamentals of Business Economics

Syllabus overview

This subject primarily covers the economic and operating context of business and how the factors of competition, the behaviour of financial markets and government economic policy can influence an organisation. It also deals with the information available to assist management in evaluating and forecasting the behaviour of consumers, markets and the economy in general.

The focus of this syllabus is on providing candidates with an understanding of the areas of economic activity relevant to an organisation's decisions and, within this context, the numerical techniques to support such decisions.

Assessment strategy

There will be a two hour computer based assessment, comprising 60 compulsory objective test questions.

Syllabus structure

The syllabus comprises the following topics and weightings:

Content area		Weighting
A	Macroeconomic and institutional context of business	25%
B	Microeconomic and organisational context of business	30%
C	Informational context of business	20%
D	Financial context of business	25%
		100%

BA1A: Macroeconomic and institutional context of business (25%)

Learning outcomes

On completion of their studies, students should be able to:

Lead	Component	Level	Indicative syllabus content
1. Explain the principal factors that affect the level of a country's national income and the impact of changing economic growth rates and prices on business.	a. Explain determination of macroeconomic phenomena, including equilibrium national income, growth in national income, price inflation, unemployment, and trade deficits and surpluses. b. Explain the stages of the trade cycle and the consequences of each stage for the policy choices of government. c. Explain the main principles of public finance (i.e. deficit financing, forms of taxation) and macroeconomic policy. d. Describe the impacts on business of potential policy responses of government, to each stage of the trade cycle. e. Calculate indices for price inflation and national income growth using either base or current weights and use indices to deflate a series.	2 2 2 2 3	• The causes of changes to the equilibrium level of national income using an aggregate demand and supply analysis and the elements in the circular flow of income. • The trade cycle and the implications for unemployment, inflation and trade balance of each stage and government policy for each stage. • The main principles of public finance: the central government budget and forms of direct and indirect taxation. • The main principles of public finance: fiscal, monetary and supply side policies, including relative merits of each. • The effects on business of changes in the economic growth rate, interest rates, government expenditure and taxation. • Index numbers.
2. Explain the factors affecting the trade of a country with the rest of the World and its impact on business.	a. Explain the concept of the balance of payments and its implications for government policy. b. Identify the main elements of national policy with respect to trade. c. Explain the impacts of exchange rate policies on business.	2 2 2	• The causes and effects of fundamental imbalances in the balance of payments. • Policies to encourage free trade and protectionist instruments. • The effect of changing exchange rates on the profits of business and international competitiveness.
3. Explain the influences on economic development of countries and the effects of globalisation on business.	a. Explain the concept of globalisation and the consequences for businesses and national economies. b. Explain the role of major institutions promoting global trade and development. c. Identify the impacts of economic and institutional factors using the PESTEL framework.	2 2 2	• Nature of globalisation and factors driving it (improved communications, political realignments, growth of global industries and institutions, cost differentials). • Impacts of globalisation on business including off-shoring, industrial relocation, emergence of growth markets, and enhanced competition. • Main trade agreements and trading blocks. • Principal institutions encouraging international trade. • The PESTEL framework (Political, Economic, Social, Technological, Environmental/Ecological, Legal).

BA1B: Microeconomic and organisational context of business (30%)

Learning outcomes

On completion of their studies, students should be able to:

Lead	Component	Level	Indicative syllabus content
1. Distinguish between the economic goals of various stakeholders and organisations.	a. Distinguish between the goals of profit seeking organisations, not-for-profit organisations and governmental organisations. b. Explain shareholder wealth, the variables affecting shareholder wealth, and its application in management decision making. c. Distinguish between the potential objectives of management, shareholders, and other stakeholders and the effects of these on the behaviour of the firm.	2 2 2	• Types of public, private and mutually owned organisations and their objectives. • Types of not-for-profit organisations and their objectives. • Concepts of returns to shareholder investment in the short run and long run (and the cost of capital). • The principal-agent problem, its impact on the decisions of organisations.
2. Demonstrate the determination of prices by market forces and the impact of price changes on revenue from sales.	a. Identify the equilibrium price in product or factor markets. b. Calculate the price elasticity of demand and the price elasticity of supply. c. Explain the determinants of the price elasticities of demand and supply. d. Calculate the effects of price elasticity of demand on a firm's total revenue curve.	2 3 2 3	• The price mechanism: determinants of supply and demand and their interaction to form and change equilibrium price. • The price elasticity of demand and supply. • Influences on the price elasticities of demand and supply. • Consequences of different price elasticities of demand for total revenue.
3. Explain the influence of economic and social considerations on the structure of the organisation and the regulation of markets.	a. Identify the influence of costs on the size and structure of the organisation. b. Explain the sources of market failures and the policies available to deal with them.	2 2	• Sources of internal and external economies of scale and their influence on market concentration. • Impacts of changing transactions costs on the decision to outsource aspects of a business (including network organisations, shared service centres, and flexible staffing). • Positive and negative externalities in goods markets and government responses to them including indirect taxes, subsidies, polluter pays policies, regulation and direct provision. • Impact of minimum price (minimum wages) and maximum price policies in goods and factor markets.

BA1C: Informational context of business (20%)

Learning outcomes

On completion of their studies, students should be able to:

Lead	Component	Level	Indicative syllabus content
1. Apply techniques to communicate business data as information to business stakeholders.	a. Explain the difference between data and information and the characteristics of good information. b. Identify relevant data from graphs, charts and diagrams.	2 2	• Data and information. • Graphs, charts and diagrams: scatter diagrams, histograms, bar charts and ogives.
2. Demonstrate the uses of big data and analytics for understanding the business context.	a. describe the principal business applications of big data and analytics. b. Demonstrate the relationship between data variables. c. Demonstrate trends and patterns using an appropriate technique. d. Prepare a trend equation using either graphical means or regression analysis. e. Identify the limitations of forecasting models.	3 3 3 3 2	• Use of big data and analytics to identify customer value, customer behaviour, cost behaviour and to assist with logistics decisions. • Cross-sectional and time-series analysis. • The correlation coefficient and the coefficient of determination between two variables. • Correlation coefficient: Spearman's rank correlation coefficient and Pearson's correlation coefficient. • Time series analysis – graphical analysis. • Seasonal factors for both additive and multiplicative models. • Predicted values given a time series model. • Seasonal variations using both additive and multiplicative models. • Trends in time series – graphs, moving averages and linear regressions. • The regression equation to predict the dependent variable, given a value of the independent variable. • Forecasting and its limitations.

BA1D: Financial context of business (25%)

Learning outcomes

On completion of their studies, students should be able to:

Lead	Component	Level	Indicative syllabus content
1. Explain the functions of the main financial markets and institutions in facilitating commerce and development.	a. Explain the role of various financial assets, markets and institutions in assisting organisations to manage their liquidity position and to provide an economic return to providers of liquidity. b. Explain the role of commercial banks in the process of credit creation and in determining the structure of interest rates and the roles of the 'central bank' in ensuring liquidity. c. Explain the role of the foreign exchange market in facilitating trade and in setting exchange rates.	2 2 2	• Role and functions of financial intermediaries. • Role of financial assets, markets and institutions in helping institutions regulate their liquidity position. • Role and influence of commercial banks in credit creation. • Role and common functions of central banks including their influence on yield rates and policies of quantitative easing. • Role of foreign exchange markets in facilitating international trade and in determining the exchange rate. • Governmental and international policies on exchange rates (exchange rate management, fixed and floating rate systems, single currency zones).
2. Apply financial mathematical techniques in a business decision-making context.	a. Calculate future values of an investment using both simple and compound interest. b. Calculate the present value of a future cash sum, an annuity and a perpetuity.	3 3	• Simple and compound interest. • Calculate an annual percentage rate of interest given a monthly or quarterly rate. • Annuities and perpetuities. • Discounting to find net present value (NPV) and internal rate of return (IRR).
3. Demonstrate the impact of changes in interest and exchange rates on controlling and measuring business performance.	a. Describe the impact of interest rate changes on market demand and the costs of finance. b. Calculate the impact of exchange rate changes on export and import prices and the value of the assets and liabilities of the business. c. Explain the role of hedging and derivative contracts in managing the impact of changes in interest and exchange rates.	2 3 2	• The impact of interest rates on discretionary spending, borrowing, saving, capital investment, and government borrowing and expenditure. • The impact of a change in the exchange rate on assets and liabilities denominated in a foreign currency. • The effect changing exchange rates has on measures of the economic performance of the business (costs, revenues, profits and asset values). • Forward contracts, futures and options as ways to manage the impact of changes.

Chapter

1

Microeconomic and Organisational Context I: The Goals and Decisions of Organisations

Chapter learning objectives

Upon completion of this chapter you will be able to:

- distinguish between the goals of profit-seeking organisations, not-for-profit organisations (NFPs) and governmental organisations
- explain shareholder wealth, the variables affecting shareholder wealth and its application in management decision making
- distinguish between the potential objectives of management, shareholders, and other stakeholders and the effects of these on the behaviour of the firm.

1 The nature of organisations

1.1 What is an organisation?

There are many definitions of an organisation. One definition relevant to business is 'organisations are social arrangements for the controlled performance of collective goals.' **(Buchanan and Huczynski)**

The key aspects of this definition are as follows:

(a) 'Collective goals' – organisations are defined primarily by their goals. A school has the main goal of educating pupils and will be organised differently from a company where the main goal is to make profits.

(b) 'Social arrangements' – someone working on their own does not constitute an organisation. Organisations have structure to enable people to work together towards the common goals. Larger organisations tend to have more formal structures in place but even small organisations will divide up responsibilities between the people concerned.

(c) 'Controlled performance' – organisations have systems and procedures to ensure that goals are achieved. These could vary from ad-hoc informal reviews to complex weekly targets and performance reviews.

Illustration 1 – Definition of organisations

For example, a football team can be described as an organisation because:

- It has a number of players who have come together to play a game.
- The team has an objective (to score more goals than its opponent).
- To do their job properly, the members have to maintain an internal system of control to get the team to work together. In training they work out tactics so that in play they can rely on the ball being passed to those who can score goals.
- Each member of the team is part of the organisational structure and is skilled in a different task: the goalkeeper has more experience in stopping goals being scored than strikers.
- In addition, there must be team spirit, so that everyone works together. Players are encouraged to do their best, both on and off the field.

Test your understanding 1

A queue of people standing at a bus stop is an example of an organisation if they all want to travel to the same place.

True/False.

Defining organisations

As yet there is no widely accepted definition of an organisation. This is because the term can be used broadly in two ways:

- It can refer to a group or institution arranged for efficient work.
- Organisation can also refer to a process, i.e. structuring and arranging the activities of the enterprise or institution to achieve the stated objectives.

There are many types of organisations, which are set up to serve a number of different purposes and to meet a variety of needs, including companies, clubs, schools, hospitals, charities, political parties, governments and the armed forces.

What they all have in common is summarised in the definition given.

1.2 Why do we need organisations?

Organisations enable people to:

- share skills and knowledge
- specialise and
- pool resources.

The resulting synergy allows organisations to achieve more than the individuals could on their own.

As the organisation grows it will reach a size where goals, structures and control procedures need to be formalised to ensure that objectives are achieved.

These issues are discussed in further detail below.

Illustration 2 – The nature of organisations

When families set up and run a chain of restaurants, they usually do not have to consider formalising the organisation of their business until they have several restaurants.

After this stage responsibilities have to be clarified and greater delegation is often required.

1.3 Classifying organisations by profit orientation

Organisations can be classified in many different ways, including the following:

Profit-seeking organisations

Some organisations, such as companies and partnerships, see their main objective as maximising the wealth of their owners. Such organisations are often referred to as 'profit-seeking'.

The objective of wealth maximisation is usually expanded into three primary objectives:

- to continue in existence (survival)
- to maintain growth and development
- to make a profit.

Not-for-profit organisations

Other organisations do not see profitability as their main objective. Such not-for-profit organisations ('NFPs' or 'NPOs – non-profit organisations') are unlikely to have financial objectives as their primary ones.

Instead they are seeking to satisfy particular needs of their members or the sectors of society that they have been set up to benefit.

Illustration 3 – NFP organisations
NFPs include the following: • government departments and agencies (e.g. HM Revenue and Customs) • schools • hospitals • charities (e.g. Oxfam, Red Cross, Red Crescent, Caritas) and • clubs.

The objectives of NFPs can vary tremendously:

- Hospitals could be said to exist to treat patients.
- Councils often state their 'mission' as caring for their communities.

- A charity may have as its main objective ‘to provide relief to victims of disasters and help people prevent, prepare for, and respond to emergencies’.
- Government organisations usually exist to implement government policy.

NFPs must stay within their budgets to survive. But their stakeholders are primarily interested in how the organisation contributes to its chosen field. This can frequently lead to tensions between financial constraints and the NFP's objectives.

Test your understanding 2

Which of the following best completes the statement 'Financial considerations are a constraint in not-for-profit organisations because...'

A they have no profits to reinvest

B they meet the needs of people who cannot afford to pay very much

C they do not have a flow of sales revenue

D their prime objectives are not financial but they still need money to enable them to reach them

Test your understanding 3

Which one of the following is not a key stakeholder group for a charity?

A employees and volunteers

B shareholders

C donors

D beneficiaries

Financial objectives in NFPs

Many NFPs view financial matters as constraints under which they have to operate, rather than objectives. For example

- Hospitals seek to offer the best possible care to as many patients as possible, subject to budgetary restrictions imposed upon them.
- Councils organise services such as refuse collection, while trying to achieve value for money with residents’ council tax.
- Charities may try to alleviate suffering subject to funds raised.

One specific category of NFPs is a mutual organisation. Mutual organisations are voluntary not-for-profit associations formed for the purpose of raising funds by subscriptions/deposits of members, out of which common services can be provided to those members.

Mutual organisations include:

- some building societies
- co-operatives
- trade unions and
- some social clubs.

Test your understanding 4

Which one of the following would not be a stakeholder for a mutual society?

A shareholders

B customers

C employees

D managers

Test your understanding 5

Some building societies have demutualised and become banks with shareholders. Comment on how this may have affected lenders and borrowers.

1.4 Classifying organisation by ownership/control

Public sector organisations

The public sector is that part of the economy that is concerned with providing basic government services and is thus controlled by government organisations.

Illustration 4 – Public sector organisations

The composition of the public sector varies by country, but in most countries the public sector includes such services as:

- police
- military
- public roads
- public transit
- primary education and
- healthcare for the poor.

Private sector organisations

The private sector, comprising non-government organisations, is that part of a nation's economy that is not controlled by the government.

Illustration 5 – Private sector organisations

Within these will be profit-seeking and not-for-profit organisations.

This sector thus includes:

- businesses
- charities and
- clubs.

Co-operatives

A co-operative is an autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly owned and democratically controlled enterprise.

(The International Co-operative Alliance Statement on the Co-operative Identity, Manchester 1995)

Co-operatives are thus businesses with the following characteristics:

- They are owned and democratically controlled by their members – the people who buy their goods or use their services. They are not owned by investors.
- Co-operatives are organised solely to meet the needs of the member-owners, not to accumulate capital for investors.

For example, a retail co-operative could comprise a group of people who join together to increase their buying power to qualify for discounts from retailers when purchasing food.

Co-operatives are similar to mutual organisations in the sense that the organisations are also owned by the members/clients that they exist for. However, they tend to deal primarily in tangible goods and services such as agricultural commodities or utilities rather than intangible products such as financial services. However, such co-operatives as the Co-Op in the UK have diversified into insurance and legal services.

Test your understanding 6

Which of the following are usually seen as the primary objectives of companies?

(i) To maximise the wealth of shareholders

(ii) To protect the environment

(iii) To make a profit

A (i), (ii) and (iii)

B (i) and (ii) only

C (ii) and (iii) only

D (i) and (iii) only

Test your understanding 7

Many schools run fund-raising events such as fêtes, where the intention is to make a profit. This makes them 'profit-seeking'.

True or False?

2 Shareholder wealth

2.1 Maximising shareholder wealth

As stated above, companies have the primary objective of maximising shareholder wealth. This should ultimately be reflected in

- higher share prices
- higher dividend payments.

The role of the managers within the business is to make decisions that will affect the value of the company and therefore the value of shareholder wealth.

Attempts to measure and increase shareholder value have focussed on incorporating three key issues:

- Cash is preferable to profit

  Cash flows have a higher correlation with shareholder wealth than profits.

- Exceeding the cost of capital

  The cost of capital represents the cost to the company of providing appropriate returns to the investors. For instance if an equity shareholder requires a 15% return in order to be encouraged to buy shares, the company therefore has a 15% cost of securing equity finance and providing that return (in the form of dividends and growth in share price).

The return, however measured, must be sufficient to cover the cost of all long-term finance, both equity and debt (for example by exceeding interest payments on the debt). Earnings made above the cost of capital will lead to growth in the business value.

- Managing both long- and short-term perspectives

  Investors are increasingly looking at long-term value. When valuing a company's shares, the stock market places a value on the company's future potential, not only its current profit levels.

Profit versus cash

Profits are calculated as sales less expenses. Net cash flows are cash receipts less cash payments. Profits and net cash flows are not the same.

For instance, if sales of $1,000 are made on credit and only 75% of these have been paid so far then the cash flow in relation to the sales is only $750.

Cash is more important to investors than profits. Their returns are received either in the form of dividends (cash received by the investor from a distribution of profits made by the company) or in the form of a capital gain from a rise in share price (and therefore the potential to earn more cash from sale of the shares).

Share prices themselves are determined by investors' perceptions of how well the company will generate cash in the future.

Profit and shareholder value

Just because a company has made a profit, it does not follow that shareholder wealth has been increased by a level that satisfies the shareholders. Consider the following example.

EVA plc has the following financial structure:

- $100 million debt with an interest rate (pre-tax) of 6%
- $200 million equity where it is estimated that shareholders want a return of 15%.

The company has made a profit before interest and tax of $36 million and pays tax at 30%.

Comment on whether directors have achieved their objective of increasing shareholder wealth.

Solution

Let us construct a conventional company income statement:

	Working	$m
Profit before interest and tax		36
Interest	100 × 6%	(6)
Profit before tax		30
Tax @ 30%		(9)
Profit after tax (available to s/holders)		21
Minimum profit required by shareholders	200 × 15%	30

The company has made a profit.

However, the way we prepare income statements does not show the return required by shareholders. In this example the profit is not enough to cover the "cost of equity" and the company could be said to have reduced shareholder value.

Note also that due to the differences between cash and profit values, earning a profit doesn’t necessarily mean that the cash has increased by the same amount.

Profits, and the cash generated, belong to the shareholders, whether or not they are paid out as dividends. Cash not paid out can be reinvested into the business to help it grow and increase the share price (and therefore shareholder value) over the long-term.

2.2 Short-term measures of financial performance

It is quite possible that financial performance of a business in the short-term could be different to its performance in the long-term. Thus measures are needed both of short-term and long-term financial performance.

Two standard measures of short-term performance are:

1 return on capital employed

2 earnings per share.

Return on capital employed (ROCE)

$$\text{ROCE} = \frac{\text{profit before interest and tax}}{\text{average capital employed}} \times 100\%$$

Comments:

- ROCE gives an indication as to how well a business uses its capital (or the assets purchased with the capital) to generate profits.
- Being a percentage makes it easy to compare the ROCE of different companies.

Another similar measure of the return to shareholders' capital is:

$$\text{Return on net assets (RONA)} = \frac{\text{operating profit (before interest and tax)}}{\text{total assets minus current liabilities}} \times 100\%$$

The higher the figure for ROCE or the return on net assets is, the more profitable the company is. However, ROCE is a measure of the net income generated by the business and not about where that income goes. Shareholders will be more interested in profits after the payment of interest and tax.

Earnings per share (EPS)

As its name suggests, EPS determines the profits available to ordinary shareholders, expressed per share.

$$\text{EPS} = \frac{\text{profits after interest, tax and preference share dividends}}{\text{number of ordinary shares issued}}$$

Of course this figure only gives the earnings per share that each owner of ordinary shares might expect to receive. It is up to the Directors to decide whether/how much to pay out as a dividend.

Furthermore, to calculate a rate of return for the shareholder, the price that the potential shareholder has to pay to acquire a share must be taken into account.

Note that the main weakness of both ROCE and EPS is that they do not correlate directly to the goal of maximising shareholder wealth.

Test your understanding 8

The following is an extract from the accounts of EBG.

	$000
Revenue	500
Cost of sales	200
Gross profit	300
Distribution costs	100
Admin. expenses	50
Operating profit	150
Interest	10
Profit before tax	140
Taxation	30
Profit after tax	110
Capital employed	3,000
Share capital (1 million shares @ $1)	1,000

Calculate

(a) ROCE

(b) EPS

Test your understanding 9

RGP currently has an eps figure of 10c with 1 million shares in issue. A proposed new project will increase profit after tax by $25,000 per annum and will be financed by the issue of a further 400,000 shares.

Calculate the new eps and indicate how shareholders will perceive the change.

2.3 Long-term measures of financial performance

In addition to measuring current financial performance, companies also need to be able to measure longer-term performance, in particular, in relation to investment. In this case it is important that a business can be sure that returns to shareholders are at least equal to the cost of acquiring the capital required to produce a long-term flow of earnings.

In making these sorts of assessment several problems arise:

- establishing the cost of capital to finance the investment project
- estimating the flow of income derived from the capital investment over the whole life of the investment
- valuing that flow of income.

To solve these problems we calculate the present value of future cash flows by a process of discounting. See later chapter on 'Discounting and Investment Appraisal'.

2.4 Share values

The concept of discounted cash flows can be used to explain how press releases and market rumours can affect the share price.

- Suppose the company announces a new project. If the market believes that the project will deliver a positive net present value, then the share price should rise. You will see in more detail in a later chapter that the net present value (NPV) of a project is the sum of the discounted future cash flows minus the capital cost of the project.
- Any information that reaches the market that suggests that future cash flows will be higher than previously forecast should result in a share price rise.
- If bad news reaches the market then as well as revising forecast cash flows downwards, investors may reassess the investment as having higher risk. This will result in a higher cost of capital and thus future receipts will be less valuable than previously estimated. The end result is a fall in the share price.

Many variables will affect the value of shares. These tend to fall into two groups:

1. factors **external** to the business which may affect a wide range of shares: the onset of a recession would tend to depress share values in general, as would a rise in interest rates
2. factors **internal** to the business that might affect the future flow of profits such as the failure of a new product, an expected decline in sales or a significant rise in costs.

Illustration 6 – Share values

BP

After the oil spill catastrophe in 2010, BP's share value fell by 47% to their lowest level in 13 years. This fall could be explained as the market revising (downwards!) its estimates over BP's future cash flows, in particular:

- Incorporating potential costs in cleaning up the damage caused
- Possible US government action
- BP's ability to win new contracts in the longer term.

In addition the shares would have been seen as a higher risk (effectively resulting in a higher discount rate being applied to the cash flows).

Recovery since 2010

Many UK companies have seen a rise in their share prices since 2010 due to:

- increased confidence that the worst of the recession is over
- expectations that low interest rates would continue for some time
- prospects that economic growth may continue.

Test your understanding 10

A company has released a press statement publicising its plans to develop a new product range in order to enter a high growth market.

Consider how the concept of discounted cash flows could be used to determine the likely impact of the announcement on the company's share price.

3 Stakeholders

Stakeholders are "those persons and organisations that have an interest in the strategy of an organisation". Stakeholders normally include shareholders, customers, staff and the local community.

It is important that an organisation understands the needs of the different stakeholders as they have both an interest in the organisation and may wish to influence its objectives and strategy.

Useful definitions:

(a) **Stakeholder interest** – an interest or concern that a stakeholder has in an organisation's actions, objectives or policies.

(b) **Stakeholder influence** – the level of involvement that a stakeholder has in the functions of an organisation and the ability to bring about a desired change.

The degree of interest and influence of different stakeholder groups can vary considerably:

- A well organised labour force with a strong trade union will be able to exercise considerable influence (e.g. through strike action) over directors' plans and will be particularly interested in any plans that relate to jobs, working conditions and the welfare of staff.
- The residents of a small village might have great interest in the plans of a major supermarket chain to close the local village store but would have little power to influence the decision.

Stakeholders can be broadly categorised into three groups: internal (e.g. employees), connected (e.g. shareholders) and external (e.g. government).

3.1 Internal stakeholders

Internal stakeholders are intimately connected to the organisation, and their objectives are likely to have a strong influence on how it is run.

Internal stakeholders include:

Stakeholder	**Need/expectation**	**Example**
Employees	pay, working conditions and job security	If workers are to be given more responsibility, they will expect increased pay.
Managers/ directors	status, pay, bonus, job security	If growth is going to occur, the managers will aim for increased profits, leading to increased bonuses.

3.2 Connected stakeholders

Connected stakeholders can be viewed as having a contractual relationship with the organisation.

The objective of satisfying shareholders is taken as the prime objective which the management of the organisation will need to fulfil. However, customer and financiers' objectives must be met if the company is to succeed.

Stakeholder	**Need/expectation**	**Example**
Shareholders	steady flow of income, possible capital growth and the continuation of the business	If capital is required for growth, the shareholders will expect a rise in the dividend stream.
Customers	satisfaction of customers' needs will be achieved through providing value-for-money products and services	Any attempt to, for example, increase the price, may lead to customer dissatisfaction.

Suppliers	paid promptly	If a decision is made to delay payment to suppliers to ease cash flow, existing suppliers may cease supplying goods.
Finance providers	ability to repay the finance including interest, security of investment	The firm's ability to generate cash.

3.3 External stakeholders

External stakeholders include the government, local authority etc. This group will have quite diverse objectives and have varying ability to ensure that the organisation meets their objectives.

Stakeholder	**Need/expectation**	**Example**
Community at large	The general public can be a stakeholder, especially if their lives are affected by an organisation's decisions.	E.g. local residents' attitude towards out-of-town shopping centres.
Environmental pressure groups	The organisation does not harm the external environment.	If an airport wants to build a new runway, the pressure groups may stage a 'sit in'.
Government	Company activities are central to the success of the economy (providing jobs and paying taxes). Legislation (e.g. health and safety) must be met by the company.	Actions by companies could break the law or damage the environment and governments therefore control what organisations can do.
Trade unions	Taking an active part in the decision-making process.	If a department is to be closed the union will want to be consulted and there should be a scheme in place to help employees find alternative employment.

Test your understanding 11

Which of the following is not a connected stakeholder?

A Shareholders

B Suppliers

C Employees

D Customers

Test your understanding 12

R is a high class hotel situated in a thriving city. It is part of a worldwide hotel group owned by a large number of shareholders. Individuals hold the majority of shares, each holding a small number, and financial institutions own the rest. The hotel provides full amenities, including a heated swimming pool, as well as the normal facilities of bars, restaurants and good quality accommodation. There are many other hotels in the city, all of which compete with R. The city in which R is situated is old and attracts many foreign visitors, especially in the summer season.

Who are the main stakeholders with whom relationships need to be established and maintained by management? Explain why it is important that relationships are maintained with each of these stakeholders.

4 Stakeholder conflict

The needs/expectations of the different stakeholders may conflict. Some of the typical conflicts are shown below:

Stakeholders	Conflict
Employees versus managers	Jobs/wages versus bonus (cost efficiency)
Customers versus shareholders	Product quality/service levels versus profits/dividends
General public versus shareholders	Effect on the environment versus profit/dividends
Managers versus shareholders	Revenue growth versus profit growth

Solving such conflicts will often involve a mixture of compromise and prioritisation.

Resolving stakeholder conflict

To help resolve stakeholder conflict, many firms will try to assess both the degree of interest of stakeholders and their power/influence to affect the business.

For example, the government may have high power but may be relatively uninterested in the affairs of a particular company. On the other hand a major key customer may have both influence and interest and so must be incorporated in any significant decisions as a "key player".

With companies the primary objective of maximising shareholder value should take preference and so decision making is simplified to some degree. However, this does not mean that other stakeholders are ignored. For example

- If we do not pay employees a fair wage, then quality will suffer, ultimately depressing profits and shareholder wealth.

Some firms address this by seeing shareholder wealth generation as their primary objectives and the needs of other stakeholders as constraints within which they have to operate:

- We try to increase profit subject to ensuring good working conditions for employees, not polluting the environment, etc.

Stakeholder conflict for NFPs

Unlike firms, NFPs (not-for-profit organisations) may not have one dominant stakeholder group. Consequently the NFP seeks to satisfy several different groups at once, without having the touchstone of one primary objective, such as profit, to adhere to.

For example, a council may express its mission as ‘caring for the community’. Suppose it is considering building a new car park in the city centre where there is currently a small green park. This would affect the community as follows:

- Local businesses would see more trade.
- More jobs would be created for local residents.
- Better parking for shoppers.
- More traffic, congestion and pollution for local residents.
- Loss of a park, thus reducing the quality of life for locals.
- The receipts from the car park could be used to reduce council tax bills and/or fund additional services for the community.

This type of decision is particularly difficult as:

- How do you decide which stakeholder group should take preference?
- Most of the factors being considered are very difficult to quantify (e.g. quality of life) and
- How do you offset different issues measured in different ways (e.g. how many extra jobs justify the extra congestion and pollution?)

Some public sector organisations try to quantify all of the issues financially to see if the benefits outweigh the costs (‘cost-benefit analysis’).

For example, congestion will delay people, thus adding to journey times. The value of people’s time can be estimated by looking at the premium they will pay for quicker methods of transport such as train versus coach.

5 Management objectives

As mentioned above, the role of the managers in a company is to make decisions that ultimately lead to an increase in shareholder wealth, for instance by sourcing and investing in projects whose returns exceed the company’s cost of capital. Of course, this may not be achieved due to the managers making poor decisions.

However, another reason for it not being achieved could be due to the managers and shareholders being different types of stakeholders and therefore having different objectives.

An extremely important stakeholder conflict is that between these two stakeholder groups.

5.1 The principal – agent problem

In some, usually small, companies the owners also manage the business.

However, companies that are quoted on a stock market are often extremely complex and require a substantial investment in equity to fund them. They therefore often have large numbers of shareholders.

These shareholders delegate control to professional managers – the board of directors – to run the company on their behalf. Thus shareholders normally play a passive role in the day-to-day management of the company.

This separation of ownership and control leads to a potential conflict of interests between directors and shareholders. This conflict is an example of the principal – agent problem. The principals (the shareholders) have to find ways of ensuring that their agents (the managers) act in their interests.

The principal – agent problem

In any organisation there are:

- **principals**: in the case of companies the principals are the legal owners of the organisation – the shareholders
- **agents**: those appointed by the principals to act on their behalf such as the board of directors and senior managers in a company.

The problem posed by agency theory is how can the principal ensure that the agent will behave in such a way as to achieve the aims and intentions of the principal? There is clearly the possibility of conflict in that the agent may act to achieve a set of objectives reflecting their self-interest and own objectives rather than those of the principals. In companies the board of directors and/or senior management may pursue objectives that are not the same as those of the shareholders. In effect, the shareholders may lose control of the companies they legally own.

How might the aims and objectives of management differ from those of shareholders?

- Management will have to balance the interests of different stakeholders in the company. Since these stakeholders have a variety of objectives, profit is unlikely to be the sole aim of management.
- Management may have objectives of its own. These may include salaries, non-salary benefits ('perks'), power, status and prestige, safety and security and a 'quiet life'. The problem with these is that they may conflict with the objectives of profitability. For example, many of the management's objectives, such as salary, power and prestige, may be related more strongly to the size of the company (sales, market share, number of employees) than to the underlying profitability of the company (return on capital employed).
- Focus on short-term objectives at the expense of long-term ones

  Common short term objectives include

  - sales maximization – this is often simpler than profit maximisation as it excludes costs. Focusing on sales may mean sacrificing profitability, e.g. offering discounts to generate more sales. Proponents would argue that higher sales usually results in greater profit

– growth maximisation – in the longer term a larger company is likely to be more profitable due to increased revenue and cost economies of scale. But if growth is at the expense of profitability, shareholder wealth can suffer

– "satisfying" – for example trying to achieve sales growth subject to a minimum increase in profit of 5%. Such targets are often seen as more practical than "maximise profits", which is seen as unachievable. Managers may want to do ‘just enough’ to achieve their targets (and perhaps their bonuses) in a particular year, rather than strive for maximising shareholder wealth, so that next year’s targets will also be achievable.

5.2 Possible areas of conflict

The main areas where managers may not act in the shareholders’ best interests are as follows:

- ‘Fat cat’ salaries and benefits – the media regularly highlight cases where directors are paid huge bonuses despite the company they manage making a loss. In many cases directors deserve their high salaries but not in all cases.
- Mergers and acquisitions – research suggests that the majority of acquisitions erode shareholder value rather than create it. Some argue that the reasons such takeovers occur is because directors are looking to expand their own spheres of influence rather than focus on shareholder value.
- Poor control of the business – the Enron and WorldCom scandals in the US in 2002 resulted in calls to improve the control that stakeholders can exercise over the board of directors of the company.
- Short-termism – managers may make decisions to maximise short-term profitability to ensure they get bonuses and hit targets, rather than looking at the long-term. For example, a project that creates wealth in the long run but is loss-making in the first two years may be rejected.

Attempts to resolve this conflict can take a number of forms:

- Corporate governance (see below) tries to improve ways companies are run through a mixture of principles and regulation.
- A review of the remuneration and bonus schemes given to directors. For example high bonuses linked to profit may encourage short-termism that ultimately undermines the long-term prospects of the business. Some firms are looking to reward directors using shares (or share options) to ensure goal congruence.

5.3 The objectives of corporate governance

Corporate governance is defined as 'the systems by which companies and other organisations are directed and controlled'.

As the name suggests, corporate governance is concerned with improving the way companies are governed and run. In particular it seeks to address the principal – agent problem outlined above.

The main objectives are as follows:

- to control the managers/directors by increasing the amount of reporting and disclosure
- to increase level of confidence and transparency in company activities for all investors (existing and potential) and thus promote growth in the company
- to increase disclosure to all stakeholders
- to ensure that the company is run in a legal and ethical manner
- to build in control at the top that will ‘cascade’ down the organisation.

Corporate governance should thus be seen as the system used to direct, manage and monitor an organisation and enable it to relate to its external environment.

e.g

Illustration 7 – Corporate Governance principles

Corporate governance is one way of trying to manage the principal – agent problem. While rules and principles vary across the world, typical aspects include the following:

- the board of directors should meet on a regular basis and that active responsibilities at board level should be spread over the board and not concentrated in a few hands; in particular, the roles of chairperson and chief executive should be kept separate
- directors should have limited contracts (e.g. 3 years) and all director reward and payments should be publicly disclosed
- there should be three sub-committees of the board: an audit committee, a nominations (to the board) committee and a remunerations (of board members) committee
- greater use should be made of non-executive directors with no direct financial interest in the company in order to provide some independence within the board, especially on the board’s sub committees
- the annual accounts should contain a statement, approved by the auditors, that the business is financially sound and is a going concern.

Test your understanding 13

In the case of ALD, a company which makes personalised gifts, which of the following is not a prime objective of corporate governance:

A to control directors' activities

B to improve the way the company is run

C to improve employees' working conditions

D to protect shareholder interests

The UK Corporate Governance Code

The UK Corporate Governance Code (2010) represents 'best practice' in corporate governance and what may be seen as a model for companies to adopt. The main features of this model are:

- separation of powers especially in relation to roles of the chairman and the chief executive
- board membership to include an appropriate balance especially in relation to executive and non-executive directors
- the adoption of the principles of transparency, openness and fairness
- to adopt an approach which reflects the interests of all stakeholders
- to ensure that the board of directors are fully accountable
- detailed disclosure and reporting requirements
- remuneration committees to determine the pay of directors
- nomination committees to oversee appointments to the board
- arrangements for organising the Annual General Meeting (AGM).

Test your understanding 14

Answer the following questions based on the preceding information.

1 What does ROCE mean and what does it measure?

2 Identify four different types of not-for-profit organisations.

3 Explain what is meant by the term stakeholders.

4 Identify five stakeholders for a typical business.

5 Explain what is meant by the principal – agent problem.

6 Give two reasons why shareholders may lose control of the company they own.

7 What is meant by the term corporate governance?

6 Transaction costs

A company has a choice for any economic activity: performing the activity in-house or going to market. In either case, the cost of the activity can be decomposed into production costs, which are direct and indirect costs of producing the good or service, and transaction costs, which are other (indirect) costs incurred in performing the economic activity, for example the expenses incurred through outsourcing, including network organisations, shared service centres and flexible staffing.

Managers are faced with a choice as to whether performing an activity in-house or choosing to outsource it will be the better decision from a shareholder wealth point of view.

If an activity is outsourced, it can be difficult to determine the transaction costs. But the decision as to whether or not an economic activity should be outsourced depends critically on transaction costs.

Transaction costs will occur when dealing with an external party.

- Search and information costs – to find the supplier
- Bargaining and decision costs – to determine contractual obligations
- Policing and enforcement costs – to monitor quality.

The way in which a company is organised can determine its control over transactions, and hence costs. It is in the interests of management to internalise transactions as much as possible, to remove these costs and the resulting risks and uncertainties about prices and quality.

The variables that dictate the impact on the transaction costs are:

- Frequency: how often such a transaction is made.
- Uncertainty: long-term relationships are more uncertain, close relationships are more uncertain, lack of trust leads to uncertainty.
- Asset specificity: how unique the component is for the business needs.

6.1 When transaction costs change

It is worth noting that changes in transaction costs, due to factors such as better information systems, flexible contracts and so on, have called into question the need for traditional organisational forms and for vertical integration.

If transaction costs reduce, for instance if the drawing up of legal documents is made easier by changes in laws, or if a new supplier is willing to self-regulate to a higher quality level, then the cost of outsourcing will decrease relative to undertaking the activity internally and outsourcing becomes more likely.

On the other hand, if a business is able to reduce its production costs – perhaps by consolidating regional departments into an internal shared service centre, then the decision to outsource may become less likely.

Test your understanding answers

Test your understanding 1
False. Despite having identical individual goals, there is no collective goal that motivates people to work together in any way. For example, passenger A will not be concerned if they get the last available place on a bus while passenger B has to wait for the next one.

Test your understanding 2
D NFPs are often stopped from realising all their goals by a lack of money. But making money is not their primary goal.

Test your understanding 3
B Charities, unlike companies, do not have shareholders. Charities could not operate without the work of employees and volunteers, or without donations from their donors, so these are both important stakeholder groups. The objective of a charity is to provide help or support for its beneficiaries. So beneficiaries are also an important stakeholder group.

Test your understanding 4
A Response (A) is the correct answer as a mutual society does not have shareholders but is owned collectively by its customers, for example a mutual building society is owned by its depositors.

Test your understanding 5

Mutual building societies exist for the benefit of their members. This is reflected in setting:

- interest rates for borrowers as low as possible
- interest rates for savers as high as possible.

The aim is not to make a profit so the borrowing and saving rates are moved as close as possible to each other with a small margin sufficient to cover costs.

Once it becomes a bank the building society must then seek to maximise shareholder wealth and become profit seeking. This is done by increasing borrowing rates and reducing saving rates.

Members will thus find that the terms offered by the building society become less attractive.

However, when demutualising most building societies give their members windfalls of shares so members become shareholders, thus benefiting from dividends and share price increases.

Test your understanding 6

D

While protecting the environment is to be encouraged and is reinforced within statute to some degree, it is not a primary objective of the company. Companies exist primarily to maximise the return to their owners.

Test your understanding 7

False

Schools run fund-raising activities to help pay for extra books, e.g. to improve the quality of education given to pupils. The primary objective is educational, not profit. The money made at the fête is thus a means not an end.

Test your understanding 8

(a) ROCE = operating profit/capital employed = 150/3,000 = 5%.

(b) eps = profit after tax/no of shares = 110/1,000 = 11 cents per share.

Test your understanding 9

Existing profit after tax = eps × number of shares = \$0.10 × 1 million = \$100,000

New profit after tax = \$100,000 + \$25,000 = \$125,000

New number of shares = 1 million + 400,000 = 1.4 million

New eps = \$125,000/1,400,000 = \$0.089, or 8.9 cents

This is lower than before so shareholder reaction will be negative.

Test your understanding 10

Future cash flows

Assuming the markets believe, and have confidence in, the directors' claims, then they should revise their estimates of the company's future cash flows upwards.

Cost of capital/discount rate

The new venture is likely to be seen as increasing the company's risk and hence investors will want a higher return to compensate. This will be reflected in a higher discount rate being used to discount the (revised) future cash flows.

Share price

The impact on the share price will depend on the net effect of the above factors. If the shareholders are optimistic about the future growth plans without being overly concerned about the extra risk, then the share price should increase. A fall in share price would indicate more serious concerns over the risks and/or a lack of belief that the high growth in cash flows will materialise.

Test your understanding 11

C

Employees are "internal" stakeholders.

Test your understanding 12

Internal stakeholders

The employees and managers of the hotel are the main link with the guests and the service they provide is vital to the hotel as the quality of the guests' experience at the hotel will be determined by their attitude and approach.

Managers should ensure that employees achieve the highest levels of service and are well trained and committed.

Connected stakeholders (shareholders, guests, suppliers)

The shareholders of the hotel will be concerned with a steady flow of income, possible capital growth and continuation of the business. Relationships should be developed and maintained with the shareholders, especially those operating on behalf of institutional investors who often have large shareholdings, such as pension funds. Management must try to achieve improvements in their return on investment by ensuring that customers are satisfied and willing to return.

Each guest will seek good service and satisfaction. The different types of guest will have different needs (business versus tourist) and management should regularly analyse the customer database to ensure that all customer needs are being met.

Suppliers must be selected very carefully to ensure that services and goods provided (e.g. food/laundry) continue to add to the quality of the hotel and customer satisfaction. They will be concerned with being paid promptly for goods, and maintaining a good relationship with the suppliers will ensure their continued support of the hotel.

External stakeholders (the government and the regulatory authorities)

The management of the hotel must maintain close relationships with the authorities to ensure they comply with all legislation – failure to do so could result in the hotel being closed down.

Test your understanding 13

C

While governance would ensure compliance with relevant legislation concerning employee working conditions, the primary focus is not employees per se.

Test your understanding 14

1 ROCE is the rate of return on capital employed and is a measure of the flow of profits compared to the capital employed in the business. It is thus a measure of the profitability of that capital.

2 Not-for-profit organisations include state-owned (public sector) activities, mutual societies, charities, private clubs, QUANGOs and voluntary organisations.

3 Stakeholders are those persons and organisations that have an interest in the strategy, aims and behaviour of the organisation.

4 Stakeholders may include: shareholders, management, employees, suppliers, customers, the suppliers of financial services and the local community.

5 The principal – agent problem arises when principals (such as shareholders) appoint some agents (such as directors) to act on their behalf (running a company) and cannot be sure that those agents will always act so as to promote the interest of the principals.

6 There may be a divorce of ownership from control because:

- companies may become too big for shareholders to effectively control
- companies may become too complex for shareholders to control
- individual shareholders may lack the power, knowledge, interest or time to control the companies they own.

7 The term corporate governance refers to the systems by which companies and other organisations are directed and controlled. For public companies this means the role of the Board of Directors and its relationship to the shareholders.