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The word 'expedite' in a lowercase, grey, sans-serif font. A small red dot is positioned above the 'x'.

ACCA Paper P4

Advanced Financial Management

For exams in 2010

Shareholder value is measured by the dividends that shareholders receive and by the increase in the value of their shares (capital gain).

Agency theory: addresses the risk that management will not act in the best interest of the shareholders, but will make decisions that will serve its own interests.

Examples of self-serving management behavior could include: (a) artificially boosting corporate profits in the short-term in order to earn bonuses; (b) paying too much to acquire another company for reasons of prestige or in order to “build empires”; (c) rejecting opportunities, such as takeover bids, or restructuring initiatives, that might jeopardize their positions (an orientation to maintain the “status quo”).

Transaction cost economics refer to the evaluation of corporate alternatives in search of the most beneficial outcomes for the company. As seen in the foregoing paragraph, what is best for the company may not coincide with the self-interest of the managers.

Other stakeholder conflicts

The agency problem between management and shareholders is only one of many potential conflicting interests that can exist between various stakeholder groups. A stakeholder is defined as anyone with an interest in the affairs of a company:

- Management and employees are most intimately interested in the company, since they seek to preserve employment and to collect salaries/wages. Unions represent the employees collectively, seeking job security and good wages;
- Customers, suppliers and creditors are also closely interested in a company based on financial and other benefits received;
- The public, via public interest groups and concerned citizens, may take an interest in a company for reasons of product safety and environmental concerns;
- The government has an interest in seeing that a company creates/maintains jobs and also generates corporate taxes;
- Even competitors may be regarded as stakeholders, though usually with less than generous motives.

Management must understand the power/influence and level of active interest of the various stakeholder groups in order to reconcile, or at least prioritize, and address their concerns.

Mendelow’s matrix is one tool which can be used in order to examine stakeholder influence and to actively manage the relationship with relevant stakeholders (next page).



KEY KNOWLEDGE

Corporate Governance

Corporate governance structures have been developed setting forth guidelines and principles on which corporate management is expected to conduct its business.

The need for good corporate governance has been spurred by such highly-publicized corporate scandals as the failure of Enron; however, corporate governance is not limited to the detection of fraud and crime.

Good corporate governance includes:

- Strengthening the role of non-executive directors on the board of directors;
- Holding management accountable for their actions;
- Ensuring that the interests of shareholders are protected;
- An ethical approach to behavior towards all stakeholders;
- Clear policy-making processes;
- Explicit risk management policy and monitoring systems; and
- Transparency and professionalism

Corporate governance models

There are several models of corporate governance: Shareholder-based models and (continental) European-based models.

Shareholder-based models

The US and UK are typically cited as basing their principles of corporate governance on a shareholder-based system, where shareholdings are widely dispersed among many individuals and therefore require protection:

- **Sarbanes-Oxley**: Refers to legislation in the USA that imposes corporate governance principles on publicly-quoted US corporations. It seeks to safeguard the economic interests of shareholders;
- **Combined Code**: In the UK, these are a set of principles that are voluntarily adopted by public companies

In contrast to the US/UK, there is the

- **European model**: Continental Europe has a greater prevalence of bank and industrial shareholdings, which concentrate corporate control; such interests tend to take a broader and more participatory approach to stakeholder

interests.

In Germany, for example, there is a two-tier board structure: the supervisory board and the executive/ management board. The supervisory board, which monitors the activities of the management board, has among its membership representatives from the trade union.



KEY KNOWLEDGE

The Role of Senior Financial Executive / Advisor

The CFO Role

Consistent with the principles of corporate governance outlined above, the role of the Chief Financial Officer (CFO) is to advise the board of directors of the firm in setting the financial goals of the business and its financial policies.

The Broader Context

The financial goals/strategy of the business are formulated in conjunction with the company's overall mission/strategy.

They are also coordinated with the commercial strategy/policy of the firm.

The financial policy of a firm contains the principles/guidelines and procedures/ rules by which the firm implements its financial strategy. Let's look at this concretely through the eyes of the CFO:

A CFO will typically address the following areas:

- (i) The allocation of capital and investment choices;
- (ii) Minimising the cost of capital;
- (iii) Dividend policy;
- (iv) Communicating with key constituencies;
- (v) Planning and control; and
- (vi) Risk management;



EXAMPLE

Taking each of the above areas in turn, give practical examples of the CFO's role:

(i) The allocation of capital and investment choices;

- Allocation implies that capital is scarce and that it has to be used wisely
- Financial resources are wisely employed if they meet the criteria of:
 - Efficiency;
 - Effectiveness; and
 - Transparency
- Companies choose investments and allocate capital to them based on priorities
- On what basis do they accept and reject investments?

(ii) Minimising the cost of capital;

- Following from (a), scarcity of capital means that capital has a cost and that it is the CFO's job to minimize that cost
- In essence, minimizing cost means identifying the sources of debt and equity in a combination that provides the optimal capital structure

(iii) Dividend policy;

- The CFO recommends the portion of earnings that should be withheld in the business (retention policy) and how much should be paid out to shareholders (distribution policy)

- The beneficiaries of either retention or distribution, theoretically, are the same people but timing and tax can make a difference (cash dividend or share price growth)

(iv) Communicating with key constituencies;

- Constituencies means stakeholders; communication is a key function of senior management, with key financial aspects the area of specialty of the CFO

(v) Planning and control;

- Think in terms of process:

Planning > Budgeting > Controlling > Evaluating

(vi) Risk management

- This is the systematic approach to identifying and minimizing an organisation's exposure to risk. RM is fundamental to all activities and processes of the firm; it should influence attitudes/mentalities.



KEY KNOWLEDGE

The Impact of Environmental & Ethical Issues

Environmental concerns

Issues of environmental concern and sustainability have become established and recognized agenda points for corporations. Many stakeholders are coming to expect explicit acknowledgment of such matters.

The "triple bottom line" approach expands the scope of a company's concerns, beyond the merely economic, to social and ecological as well.

Carbon trading programmes are schemes by which a company which outperforms its environmental targets is rewarded by being able to sell its credits to companies that pollute beyond permitted limits. To operate properly, this arrangement requires supervision by a central authority (government) in what is known as a "cap and

trade" regime.

Ethical Issues

An ethical approach to doing business is not just a matter of personal virtue, but needs to be addressed by policy (and action) at the company level as well. Ethical frameworks are not merely "nice to have", but are considered crucial to building long-term professionalism. Their absence can undermine motivation and the sense of purpose a company must have in order to succeed.



EXAMPLE

The purchasing manager at a company you wish to do business with offers to give you a contract in return for a personal favor. What do you do?

Financial Strategy Formulation

The areas of principal concern to the CEO, as outlined earlier in this section, form the basis of the activities and the responsibilities on an on-going basis of those individuals who are in charge of the formulation of financial strategy at the firm.