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The logo for expeditate, featuring the letters 'exp' in a grey font with a red dot above the 'x', followed by the word 'editate' in a black font.

ACCA Paper F9

Financial Management

For exams in 2010

2. Financing: Where to source the funding so as to minimize the cost of capital to the firm (equity, debt, suppliers)
3. Dividends: How much cash to allocate to the shareholders to maintain their commitment to the company while retaining appropriate resources for reinvestment

The financial management function embraces two further disciplines that can be explicitly identified:

- a) Management accounting is a set of tools and disciplines measuring corporate performance and to facilitate decision-making; it is designed and implemented in coordination with the company's strategy.
- b) Financial accounting is concerned with maintaining the records of the transactions of the firm and preparing financial statements for the benefit of shareholders (and other external audiences) in conformity with established accounting standards.



KEY KNOWLEDGE

Financial Objectives and the Relationship with Corporate Strategy

In pursuing its financial objectives, the firm must ensure that those objectives are congruent – i.e. consistent – with its overall corporate strategy.



EXAMPLE

A manufacturer of luxury watches wishes to expand into the mass-market.

What are the implications of such a move from the perspective of:

- a) Corporate strategy (incl. mission, brand, image, positioning)?
- b) Financial planning and objectives-setting?

Quantifying financial objectives

Assuming that the maximization of shareholder wealth is the overall goal of a profit-making company, financial objectives must be formulated in more specific terms.

Consider the following:

- a) Sales revenue / growth

- b) Market share / growth

- c) Profit maximization / growth

- d) Earnings per share (EPS) / growth

- e) Return on Capital Employed (ROCE)

- f) Return on Equity (ROE)

- g) Price-Earnings ratio (P/E)

- h) Dividend per share (DPS)

- i) Total shareholder return (TSR)



EXAMPLE

Statement of Financial Position (as at 31 December)

(amounts in 000's)

	<u>20x9</u>	<u>20x8</u>
Non-current assets	2,000	1,800
Current assets	<u>1,700</u>	<u>1,500</u>
	<u>3,700</u>	<u>3,300</u>
Common shares (\$1)	2,200	2,000
Reserves	285	170
Bonds	665	600
Current liabilities	<u>550</u>	<u>530</u>
	<u>3,700</u>	<u>3,300</u>

Statement of Comprehensive Income (as at 31 December)

(amounts in 000's)

	<u>20x9</u>	<u>20x8</u>
Sales	3,000	2,700
Cost of Sales	<u>(1,800)</u>	<u>(1,600)</u>
Gross Profit	1,200	1,100
SGA	<u>(800)</u>	<u>(700)</u>
Operating Profit	400	400
Interest	<u>(70)</u>	<u>(60)</u>
Profit Before Tax	330	340
Tax	<u>(100)</u>	<u>(100)</u>
Net Income	<u>230</u>	<u>240</u>
Dividend	110	120
Note: share price (end of periods)	3.10	3.20

Based on the information provided above, calculate the following:

- a) Earnings per share (EPS)
- b) Return on Capital Employed (ROCE)
- c) Return on Equity (ROE)
- d) Price-Earnings ratio (P/E)
- e) Dividend per share (DPS)
- f) Total shareholder return (TSR)



KEY KNOWLEDGE

Stakeholders and Impact on Corporate Objectives

Stakeholder groups

- Shareholders: As owners of the business, they rank supreme, as reflected in US/UK models of corporate governance;
- Lenders: Important if the business relies heavily on providers of loan capital (banks, bondholders);
- Directors: The executive directors (or senior management) of the business are central since they have "hands-on" power and can serve their own interests (giving rise to agency risk);
- Employees: Often referred to as a company's "most valuable asset"; they must be motivated and adequately compensated;

- Customers: No customers, no business! How influential they are or how carefully management needs to listen to their concerns depends on the type of business activity and the competitive environment;
- Suppliers: Good and reliable suppliers can be critical to corporate success;
- Government: They have two major interests: (a) they receive revenue via taxes and (b) benefit indirectly when firms create employment. Environmental and other regulatory concerns are also within the scope of the government's interest;
- Public: The general public, its opinions and ability to exert pressure through lobby groups are all relevant factor for businesses that pollute, are involved in nuclear power, or carry out other activities that may be controversial (e.g. abortion clinics).

Conflicting stakeholder interests

Conflicting interests can exist between various stakeholder groups.

Management must examine the degrees of stakeholder influence and actively manage the relationship with relevant stakeholders.



EXAMPLE

British Airways (BA) cabin crews threatened to go on strike during the last Christmas holidays. Discuss the various stakeholder conflicts and the choices facing management.



KEY KNOWLEDGE

Agency Theory

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 maintaining the “status quo”).



EXAMPLE

Give other examples of agency risk.

Influencing managerial behavior

In order to cause managers to behave in a way consistent with stakeholder interests, rewards and bonus schemes need to be carefully designed. This can be seen as the “internal” dimension to corporate governance. The other dimension -- “external” – comes in the form of regulation.

Incentive schemes

Rewarding management for good performance comes in a variety of forms:

- Performance-Related Pay (PRP): This may be a cash bonus paid as a result of achieving some pre-defined target, such as profits, EPS, share price, etc.;
- Option schemes: Granting executives call options on company shares; or
- Combinations of the above.

The main challenge to such schemes is the temptation by managers to “game” the system in the short-term.



EXAMPLE

The controversy over bankers' bonuses following the financial crisis of 2008-09 portrays the difficulty to reconcile long-term interests of the firm with the short-term interests of managers. Discuss.

Regulatory schemes

Corporate governance structures have been developed setting forth guidelines and principles by which corporate management is expected to conduct its business activities and in particular its relationships with stakeholders.

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;
- Interest of shareholders are protected
- Ethical approach to behavior towards all stakeholders
- Clear policy-making processes with transparency
- Explicit risk management policy and monitoring systems

Combined Code

In the UK, this is a set of principles of good corporate governance which sets forth a code of best practice aimed at companies listed on the London Stock Exchange. It is overseen by a body called the Financial Reporting Council.

Split Chairman-CEO roles

"The roles of chairman and chief executive should not be exercised by the same individual."
(Code: A.2.1)

Independence of Non-executive Directors

The board should identify in the annual report each non-executive director it considers to be independent." (Code: A.3.1.)

Board Composition

"...at least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent. (Code: A.3.2.)

Nomination Committee

"A majority of members of the nomination committee should be independent non-executive directors." (Code: A.4.1.)

Audit Committee

"The board should establish an audit committee of at least three, or in the case of smaller companies, two, members, who should all be independent non-executive directors." (Code: C.3.1.)

Remuneration

The remuneration committee should have

- "...delegated responsibility for setting remuneration for all executive directors and the chairman, including pension rights and any compensation payments.";
- "... recommend and monitor the level and structure of remuneration for senior management. (Code: B.2.2.)

"The board itself or.....the shareholders should determine the remuneration of the non-executive directors...." (Code: B.2.3.)

Sarbanes-Oxley

In the US, Sarbanes-Oxley is Federal legislation dating from 2002 that prescribes corporate governance principles for publicly-quoted US corporations. It seeks to safeguard the economic interests of the shareholders, by promoting an active market where corporate control can change hands in an effort to promote the most efficient allocation of economic resources.



KEY KNOWLEDGE

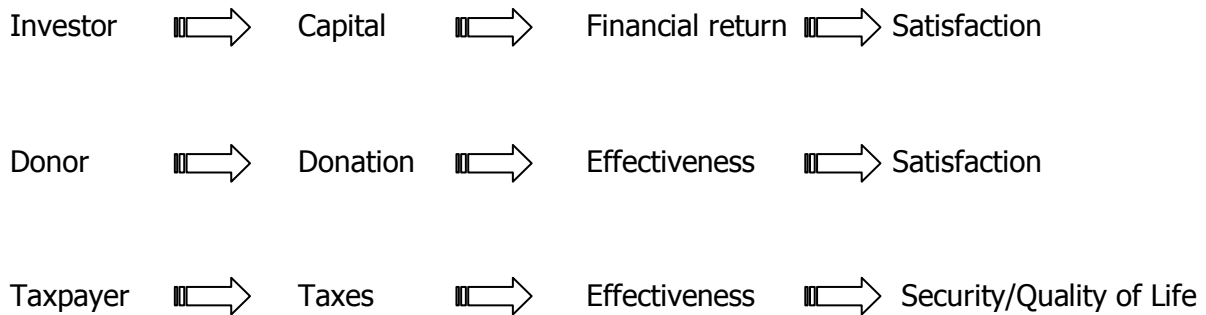
Financial and Other Objectives in Non-for-Profit Organisations

Profit and Not-for-profit organisations

Profit-seeking organizations exist ultimately to create wealth for their owners.

Non-profit (or not-for-profit) organizations are created to accomplish a pre-defined mission, such as the delivery of a service; they are expected to do so in an economical manner.

Unlike business organizations, the word "profit" is removed from the vocabulary of "not-for-profit" organizations; however, everything else remains applicable to such entities.



Achieving "Value for Money" : The 3 E's

- **Economy**

Getting the best deal on inputs

- **Efficiency**

Converting inputs into the maximum number of outputs

- **Effectiveness**

Ensuring that organizational objectives are being met



KEY KNOWLEDGE Financial Management Environment

1. The economic environment for business

The general economic environment, and in particular the influence of governments – through its monetary and fiscal policies – has a far-reaching impact on most businesses.

Key concepts

Macroeconomic policy targets

Governments are generally concerned with pursuing policies that promote (1) Economic (GDP) growth; (2) Full employment (at decent wages); (3) Price stability and (4) Balance of payments stability.

Fiscal policy: refers to actions by the government via (1) Government spending and (2) Taxation policy in pursuit of the macroeconomic targets (mentioned above).

Monetary policy: refers to the actions of a central bank in controlling (1) the supply of money and (2) the level of interest rates in the economy. These actions have an impact on the level of business investment, exchange rates and export performance of the economy and, ultimately, the achievement of macroeconomic targets.

The impact of government policy on businesses: Two key mechanisms that influence business decisions and the level of business investment are (1) the level of interest rates (stemming from monetary policy) and (2) the level of corporate taxation (fiscal policy).

All the factors mentioned above interact with one another in search of "equilibriums":

- (a) If the government spends more than it receives (i.e. incurs a "budget deficit"), then this may have an impact on the level of interest rates across the economy;
- (b) If a national economy spends more on imports than it receives from exports and other earnings, then it may suffer a "balance of payments" deficit. In this case, there may be a negative impact on inflation (read: higher) and on the exchange rate (read: lower) of the country. A lower exchange rate means that imports become more expensive.

Be sure to read international business/economic literature in order to be up-to-date with economic policy developments in your country and in the global economy.

Further examples of government policies and their impact on business:

- 1) Competition policy: Government ensures that conditions of "fair" competition prevail in the economy (regulatory entities may also be referred to as a "monopoly" commission);
- 2) Assistance for business: Government policies seeking to support businesses, usually via tax incentives and subsidies. Sometimes such support is challenged by other firms on the grounds of "unfair" competition;
- 3) Green policies: Refers to government actions in the protection of the environment;
- 4) Corporate governance regulation: As described earlier.

Recall: The Combined Code (UK) is voluntary; Sarbanes-Oxley (USA) is mandatory

2. The nature and role of financial markets and institutions

Financial markets and institutions have achieved such a degree of global integration that shocks in one part – as shown with the onset of the financial crisis in 2008 – can have systematic implications across all markets.

Money Market

Exists for the issuance and trading of short-term debt instruments, such as:

Treasury bills;

Repurchase agreements (Repos);

Certificates of Deposit;

Commercial paper;

Bankers Acceptances

Capital market

Facilitates the issuance and trading of long-term debt and equity securities, such as:

Bonds (secured or unsecured – Note: Debentures refer to the unsecured variety)

Equities (shares)

Financial intermediaries

This refers to institutions that stand between borrowers and lenders for the purpose of making savings available to businesses so that investment can take place.

Why is intermediation possible?



EXAMPLE

A bank typically has the following advantages in acting as intermediary:

- 1) Liquidity preferences: The bank can intermediate the difference in liquidity functions between households and businesses by turning current account deposits into fixed maturity loans;
- 2) Mobilization of funds: Larger transactions can be supported by collecting lots of small savings from depositors;
- 3) Information costs (search, verification, monitoring, enforcement); The bank can limit the problems of adverse selection and moral hazard;
- 4) Spreading losses from lending: Banks can pool a portfolio of loans, thus cushioning the impact of a loss from any specific transaction

Disintermediation refers to the process by which end savers and borrowers “connect” without the intervention of a bank.

Stock market

The stock market is an organized exchange on which companies can list their shares for trading purposes. A company’s initial listing is called an Initial Public Offer (IPO), which involves making new or existing shares available to the general public. A company already listed on the stock market can then make subsequent issuances of shares as funding needs arise.

Bond market

The bond market is an organized exchange where investors can buy and sell debt securities. Bonds can be government issued (i.e. risk free) or corporate.

In the USA, both shares and bonds are traded on the NY stock exchange (NYSE).

Risk/Return tradeoffs

Using the (money market and capital market) instruments mentioned above as examples, explain the nature of the risk-reward relationship exhibited.