

# Paper 3

## Financial strategy

### AIM

To develop an understanding of the role of financial strategy in the investing, financing and resource allocation decisions within an organisation.

### OBJECTIVES

On completion of this paper, candidates should be able to:

- Explain the role and nature of financial strategy and its relationship to shareholder value
- Identify the main elements of investment appraisal
- Evaluate long-term decision opportunities through the use of appropriate techniques
- Identify and evaluate the major sources of finance available to an organisation
- Explain the role of capital markets in raising finance
- Discuss the main methods of managing working capital and analyse working capital policies
- Evaluate the motives for, and financial implications of, mergers and acquisitions
- Discuss the impact of taxation and inflation on financial strategy decisions.

### POSITION OF THE PAPER IN THE SYLLABUS

This subject area is directly related to the management decision-making theme of the Diploma in Financial Management and links closely with the other three subject areas within the scheme. Some overlap between these subject areas is inevitable. For example, financial statements and ratios that are considered in subject area 1, fixed and variable costs and relevant and irrelevant costs that are considered in subject area 2, and gearing that is considered in subject area 4, may also be considered in this paper.

### SYLLABUS CONTENT

#### 1 The nature and scope of financial strategy

- a Financial strategy and organisational objectives
- b Finance strategy and the role of the finance function.

#### 2 Investment appraisal

- a Evaluation of long-term investment opportunities through the use of:
  - i net present value
  - ii internal rate of return

- iii accounting rate of return
  - iv payback period (including discounted payback period)
  - v profitability index
- b Advantages and disadvantages of each appraisal technique
  - c Asset replacement decisions
  - d Simple single-constraint capital rationing decisions
  - e Sensitivity analysis
  - f Methods available to approve, monitor and control investment projects
  - g Non-financial issues in investment appraisal.

#### 3 Raising finance

- a Key features of the main sources of finance, including:
  - i share capital (including forms of share issue and the redemption and repurchase of shares)
  - ii loan capital (including mezzanine finance, junk bonds, securitisation, warrants and convertibles)
  - iii leasing (including sales and lease back) and hire purchase
  - iv invoice discounting and debt factoring
  - v bills of exchange and acceptance credits
  - vi bank finance
  - vii PFI/PPP
  - viii internal sources of finance.
- b Use of forecast financial statements and financial ratios to evaluate financing proposals
- c Factors influencing the choice of financing methods
- d The effect of financing decisions on risks and returns to investors
- e The problems of overtrading
- f The cost of capital, including calculation of the:
  - i cost of equity (including a basic understanding of the capital asset pricing model)
  - ii cost of loan capital
  - iii weighted average cost of capital
- g Finance and the small business.

#### 4 Capital markets

- a The nature and purpose of stock exchanges
- b Implications of obtaining a stock market listing
- c The efficiency of the stock markets
- d Implications of market efficiency for managers and investors

- e International capital markets
- f Stock market ratios
- g The nature and role of venture capital.

### 5 Working capital

- a The nature and importance of working capital management
- b Methods employed to manage inventories, receivables and cash
- c Main elements of trade credit policy (including the main sources of information available to assess creditworthiness of a credit customer)
- d The management of trade payables and bank overdrafts
- e Financial implications of different working capital policies
- f Working capital problems of the small business.

### 6 Business combination

- a Motives for business combinations
- b Assessing the impact of a proposed combination on financial performance and shareholder wealth
- c Advantages and disadvantages of different forms of bid consideration
- d Methods available to resist a proposed takeover
- e Basic techniques for valuing a business, including:
  - i net asset approach
  - ii income flow and cash-flow approaches
  - iii dividend based approach
  - iv price-earnings ratio approach
- f Company restructuring including divestment, spin offs, management buyouts and buyins.

### EXCLUDED TOPICS

The following topics are specifically excluded from the syllabus:

- Calculations to derive discount factors. Candidates will always be supplied with discount tables
- The mathematical derivation of any formulae
- The use of statistical probabilities for measuring the risk of a particular investment or policy.

### KEY AREAS OF THE SYLLABUS

The key topics are:

- Investment decision making
- Raising finance

- Capital markets
- Working capital management
- Mergers and acquisitions
- Share valuation.

### ADDITIONAL INFORMATION

Present value tables and annuity tables will be provided in the examination. The study guide provides more detailed guidance on the syllabus.

### RELEVANT TEXTS

P F Atrill **Financial Management for Non specialists (2nd edition)** Financial Times Prentice Hall  
ISBN 0-13-022775-7

R A Brealey, S C Myers, A J Marcus **Fundamentals of Corporate Finance (2nd edition)** Irwin McGraw Hill  
ISBN 0-07-11545-0

E J McLaney **Business Finance Theory and Practice (5th edition)** Financial Times Prentice Hall  
ISBN 0-273-64636-2

Wider reading is also desirable, particularly relevant articles in the Diploma Newsletter.

### STUDY GUIDE

#### 1 The nature and scope of financial strategy

Syllabus reference 1a, b

- Broadly describe the relationship between financial strategy, management accounting and financial accounting
- Identify the possible aims and objectives of organisations, both profit seeking and non-profit seeking
- Identify the key stakeholders of a company including shareholders, lenders, directors, employees, customers, suppliers and the government and the importance of each group to the company
- Identify the role of the finance function in management decision making.

### 3 Investment appraisal – I

Syllabus reference 2a, b, f

- Explain the key features of long-term investment decisions
- Describe methods available to approve, monitor and control investment projects
- Explain the accounting rate of return and evaluate its usefulness as a measure of investment worth
- Explain the payback method and evaluate its usefulness as a measure of investment worth
- Calculate the accounting rate of return and payback period for an investment project from given data

### 4 Investment appraisal – II

Syllabus reference 2a, b

- Explain the importance of the time value of money in appraising investments
- Identify relevant cash flows relating to potential investments
- Explain the discounted payback period method and evaluate its usefulness as a measure of investment worth
- Explain the net present value and internal rate of return methods of investment appraisal and evaluate their usefulness as measures of investment worth
- Calculate the discounted payback period, net present value and internal rate of return for an investment project from given data
- Compare the net present value and internal rate of return methods
- Explain the advantages of DCF methods (net present value and internal rate of return) over payback and accounting rate of return.

### Investment appraisal – I

Syllabus reference 2a, b, f

- Explain the key features of long-term investment decisions
- Describe methods available to approve, monitor and control investment projects
- Explain the accounting rate of return and evaluate its usefulness as a measure of investment worth
- Explain the payback method and evaluate its usefulness

as a measure of investment worth

- Calculate the accounting rate of return and payback period for an investment project from given data.

### 5 Investment appraisal – III

Syllabus reference 2c, e

- Apply DCF methods to asset replacement decisions
- Identify and discuss the sources of risk affecting the viability of a project
- Analyse and evaluate the sensitivity of net present value outcomes to changes in key variables
- Evaluate sensitivity analysis as a tool of investment appraisal.

### 6 Investment appraisal – IV

Syllabus reference 2a, d, g

- Distinguish between hard and soft capital rationing
- Apply the profitability index technique to single-period, divisible projects
- Explain how non-financial factors can influence the investment decision
- Explain how inflation and taxation should be taken into account when making investment decisions.

### 7 Raising finance – I

Syllabus reference 3a

- Explain financing in terms of the risk/return trade off
- Discuss the main features of ordinary shares and preference shares
- Describe the main features of
  - straight long-term loan capital and mortgages
  - convertible loans, subordinated loans and warrants
  - deep discount bonds and junk (high yield) bonds
- Discuss the reasons for issuing each particular form of loan capital
- Distinguish between fixed and floating rates of interest
- Explain the factors to be taken into account when considering a financing choice between ordinary shares, preference shares and loan capital.

**8/9 Raising finance – II**

Syllabus reference 3a

- Explain the main advantages and disadvantages of leasing rather than purchasing assets
- Distinguish between finance leases and other leases
- Describe the main features of a sale-and-lease-back agreement and explain the advantages and disadvantages of raising finance in this way
- Explain the advantages and disadvantages of hire-purchase agreements
- Describe the main features of securitisation
- Explain the role and nature of PFI and PPP in raising finance
- Explain the importance of internally generated sources of long-term finance to a business.

**10 Raising finance – III**

Syllabus reference 3a, g

- Describe the main features of:
  - invoice discounting and debt factoring
  - bills of exchange and acceptance credits
  - bank overdrafts
- Discuss the advantages and disadvantages of the various forms of external short-term finance available to a business
- Identify and evaluate the main internal sources of short-term finance
- Describe the problems faced by small businesses seeking external finance (such as inadequate information, inadequate security, funding gap etc).

**11/12 Financing options**

Syllabus reference 3b, c, d, e

- Prepare forecast financial statements in order to examine financing options or to identify funding needs
- Analyse past, current and expected future performance of a business through the use of ratios and other techniques to examine the implications of different financing options
- Evaluate the effect of financing options on the risks and returns to investors
- Evaluate the suitability of different forms of financing for given situations

- Explain the problem of overtrading (undercapitalisation) and describe the symptoms and remedies.

**13 Cost of capital**

Syllabus reference 3f

- Explain the term 'cost of capital' and its importance in investment decision making
- Calculate:
  - cost of equity (including a basic understanding of CAPM)
  - cost of preference shares
  - cost of loan capital
  - weighted average cost of capital
- Discuss the assumptions underlying the use of weighted average cost of capital in investment decision making.

**14/16 Capital markets**

Syllabus reference 3a, 4a, b, e, f, g

Stock markets

- Outline the nature and purpose of a Stock Exchange
- Describe how stock markets operate
- Calculate, analyse and evaluate appropriate financial ratios (eg EPS, P/E dividend yield and dividend cover)
- Explain the advantages and disadvantages of a company seeking a stock market listing
- Describe the main international capital markets for bonds and equities

Share issues and redemptions

- Explain the main forms of issuing shares and the advantages and disadvantages of each method
- Describe the advantages and disadvantages of rights issues
- Calculate the price of rights
- Explain the purpose, and effect on shareholder wealth, of bonus issues, scrip dividends and share splits
- Discuss reasons for the repurchase or redemption of shares
- Identify and discuss the main types of investment that are suitable for venture capital funds
- Explain the investment process for venture capitalists and the main factors that are taken into account by venture capitalists when assessing investment potential
- Analyse and evaluate an investment proposal from the perspective of a venture capitalist.

### **17 Market efficiency**

Syllabus reference 4c, d

- Explain the term 'market efficiency'
- Describe the main forms of market efficiency
- Examine the implications of market efficiency for managers and investors
- Discuss in broad terms the applicability of the efficient market hypothesis to stock markets.

### **18 Working capital management – I**

Syllabus reference 5a, b, e

- Explain the nature and scope of working capital management
- Explain the need for effective working capital management
- Distinguish the working capital needs of different types of business
- Analyse and evaluate the financial implications of different working capital policies

Management of stock

- Calculate and interpret inventory ratios
- Explain the role of inventory in the working capital cycle
- Describe and evaluate the tools and techniques of inventory management
- Apply the basic EOQ model.

### **19 Working capital management – II**

Syllabus reference 5b, c

Management of receivables

- Explain the role of receivables in the working capital cycle
- Describe the factors to be taken into account when assessing the creditworthiness of customers
- Describe the main sources of information to assess the creditworthiness of customers
- Identify and discuss the main factors involved in deciding on terms of sale
- Explain the role of settlement discounts
- Describe policies for the effective and efficient collection of debts
- Analyse and evaluate the financial implications of different credit policies
- Calculate and interpret debtor ratios.

### **20 Working capital management – III**

Syllabus reference 5b, d

Management of cash

- Explain the role of cash in the working capital cycle
- Describe and apply the tools and techniques of cash management
- Identify and discuss the main factors to be taken into account when deciding upon the level of cash to be held
- Calculate and interpret cash ratios
- Describe methods of managing a bank overdraft.

### **21 Working capital management – IV**

Syllabus reference 5d, f

Management of creditors

- Explain the role of payables in the working capital cycle
- Describe the advantages of trade credit
- Identify the risks of taking increased credit and the role of guarantee
- Describe policies for effective management of payables
- Calculate and interpret payable ratios

Working capital management and the small business

- Explain the problems confronted by small businesses in managing working capital (eg market power, poor financial management skills, inadequate information systems).

### **22 Business combinations**

Syllabus reference 6a, b, c, d

- Explain the motives for business combinations
- Analyse and evaluate the impact of a proposed acquisition on financial performance and shareholder wealth
- Evaluate the various forms of bid consideration
- Identify and discuss the main areas for investigation when considering a proposed takeover
- Describe the methods available to resist a takeover bid.

### **23/24**

#### **Share valuation**

Syllabus reference 6e

- Explain the basic principles of valuation
- Discuss the relevance of accounting information to share valuation

- Apply share valuation methods based on:
  - Net assets
  - Income flows and cash flows
  - Dividends
  - Price earnings ratio
- Discuss the theoretical and practical limitations of the valuation methods
- Describe the practical influences on share price including reasons why share prices may differ from their theoretical values
- Explain the role of share valuation models in negotiations regarding business combinations.

## **25/26**

### **Company Restructuring**

Syllabus reference 6f

Divestments

- Describe the nature of, and reasons for, divestments
- Discuss sell-offs, spin-offs and liquidation as forms of divestment
- Analyse and evaluate the financial effects of proposals for divestment

Management buy-outs and buy-ins

- Discuss the advantages and disadvantages of buy-outs and describe the issues that a management team should address when preparing a buy-out proposal
- Assess the financial benefits of a buy-out from both the buy-out team and the financial backer
- Identify the advantages and disadvantages of management buy-ins

Going private

- Explain the reasons for a public company changing to private company status.

## **27/28**

### **Revision**